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DISCLOSURE STORIES

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I. INTRODUCTION

In a smallish but pleasant office located in a nondescript, single-story brick building on the north edge of RBS Industries' chemical manufacturing plant, Kay Burde reviews specifications for changes to one of the plant's production processes. Kay, a midlevel environmental manager for the firm, is particularly interested in the likely level of increased emissions and in why accountants in the plant's corporate headquarters characterized those changes as capital expenditures. She is interested because these two factors, taken into account with several others, guide and constrain her judgment as to whether the changes will trigger additional regulatory obligations under the

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Clean Air Act and will ultimately require her to notify the Environmental Protection Agency (EPA) of the changes and the ensuing obligations.

Up at the firm's administration building, Bill Moogan, a tax attorney in the corporate counsel's office, struggles through a close-out report regarding environmental clean-up activities at the plant. Initiated last fiscal year, the cleanup involves three elements: the construction of a soil vapor extraction system to remove hazardous, volatile contaminants from the subsurface soil, excavation and off-site disposal of tanks found buried at the plant, and installation of a groundwater "pump and treat" system designed to contain and ultimately remove contaminants from the aquifer. The firm's tax accountants recommend deducting most of those clean-up costs currently. Moogan is concerned because several Internal Revenue Service (IRS) pronouncements contend that the relevant regulations and caselaw require that a significant amount of those costs be capitalized.

Scenarios like these play out in businesses across the country every day in settings ranging from large industrial concerns such as chemical plants and refineries to small neighborhood enterprises such as dry cleaners and printers. The government relies heavily upon industry to monitor its own compliance with a wide range of health and safety and economic regulations and to disclose violations to the relevant regulatory agency. Given the astonishing number of businesses and regulations in play, it is difficult to imagine how a regulatory program of any significant size could function absent such reliance. Yet despite the apparent inevitability of self-reporting as a mainstay of enforcement policy, there is relatively little discussion regarding this form of mandatory disclosure in the relevant literature.[1]

This Article examines two questions regarding the use of disclosure as an enforcement tool. First, what is it that regulators hope to accomplish by requiring or encouraging firms to report their compli-

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1. There is, of course, significant literature regarding disclosure in the securities area. Much of that literature engages in debate over whether mandatory disclosure in the securities area is necessary or wise. *See* Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1028-34 (2000) (providing an overview of the debate). Some of the securities disclosure literature explores the failure of firm managers to disclose negative information where the information will likely become public at a later date, thus exposing the managers to reputational sanctions or legal liability. Commentators offer various persuasive accounts of why rational, good-faith managers would choose to ignore market pressures and legal obligations in such circumstances. *See, e.g.*, Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 724-27; Mitu Gulati, *When Corporate Managers Fear a Good Thing Is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. REV. 675, 689-96 (1999); Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 144 (1997).

ance status to government agencies and to others? Second, considering what we know about human nature, how confident should we be that our current disclosure systems can achieve those objectives consistently? These are, obviously, two very broad questions concerning a regulatory tool that takes many forms. Thus I cannot hope to answer those two questions fully in this Article. Instead, the Article limits the inquiry to the context of one particular form of noncompliance: strategic noncompliance.

Strategic noncompliance occurs when the firm acts in accordance with an interpretation of an ambiguous regulation that is contrary to the regulator's stated interpretation. Obviously, the firm's action is only a violation of law from the regulator's perspective, at least until some final resolution of the question is reached by a court or through further legislative or administrative action clarifying the ambiguity. Thus even generally law-abiding individuals and firms can engage in strategic noncompliance without feeling that they are violating the law. In many cases, regulators are unaware of aggressive compliance positions taken by firms and are thus unable to challenge those positions without incurring significant costs. Mandatory disclosure appears to be a good fit for this problem because it can illuminate these shadowy areas of strategic noncompliance. In this Article, I aim to explore the extent to which mandatory disclosure can open the window to the interior of the firm and reduce the incidence of strategic noncompliance by good-faith actors.

Part II lays out a brief description of my operating assumptions for this Article. In Part III, I turn to an overview of the goals and structure of disclosure regimes. At one level, disclosure is obviously intended to redistribute information from within the firm to outside parties, such as government agencies, consumers, or local communities. However, regulators typically have deeper objectives in mind when adopting a disclosure regime than simply reallocating information. In the case of enforcement, the major goals are to encourage the firm to regulate itself and to enable the regulator to take action against those firms that fail to self-regulate. These goals are pursued through three mechanisms of disclosure: the reflexive mechanism, the deterrent mechanism, and the enhancement mechanism. The reflexive mechanism, which operates even before disclosure occurs, forces the firm to look closely at its own behavior in hopes of eliciting a voluntary change in behavior. The deterrent mechanism, which also operates in the predisclosure stage, likewise attempts to change firm behavior directly, using the prospect of third-party reactions to the disclosure as the stick. The enhancement mechanism becomes active after disclosure is complete. It focuses instead on the recipient, providing critical information to spur that party into taking some action with respect to the firm.

The remaining Parts of the Article examine how well two different types of disclosure implement these important mechanisms. The two types of disclosure—binary and fuzzy disclosure—differ in how they address the ambiguity found in virtually every regulation. Binary disclosure, on its face, simply ignores the ambiguity, treating the question of compliance as a rather straightforward, black-and-white proposition. Consequently, binary disclosure provisions typically lack any "built-in" reporting standard against which compliance is measured and instead only call for disclosure in instances in which the firm independently identifies noncompliance. Fuzzy disclosure recognizes the pervasive ambiguity and builds it into the reporting standards. Thus, a fuzzy disclosure provision may require the firm to report an act or transaction as a violation if the firm lacks a reasonable basis or substantial authority for treating it as compliant.

The story is not especially favorable for either type of disclosure in terms of their likely capacity to fend off strategic noncompliance, although binary disclosure fares far worse than fuzzy. Part IV of the Article identifies potentially powerful social, motivational, and cognitive factors that can prod firm managers into engaging in strategic noncompliance. If activated, the reflexive and deterrent mechanisms of disclosure may offset these factors and cause the firm managers to adopt less aggressive interpretations of ambiguous regulations. However, absent an obvious violation, it is doubtful that binary disclosure would trigger these mechanisms. Because binary disclosure does not set out a reporting standard for evaluating compliance status, the firm will rely on the same standard in assessing compliance for purposes of the disclosure provision as it did for evaluating compliance with the underlying substantive obligation. Thus the firm manager will be unlikely to conclude that disclosure is necessary.

Part V turns to fuzzy disclosure, demonstrating that it has greater potential to deal with strategic noncompliance than binary disclosure. Assume that a fuzzy disclosure provision establishes a conservative reporting standard for identifying noncompliance. In that case, a good-faith actor engaged in strategic noncompliance on the basis of an aggressive, arguably reasonable legal position may feel the normative obligation to disclose the position. Once that obligation is felt, a number of conscious and preconscious influences that support the reflexive, deterrent, and enhancement mechanisms may be triggered. Nonetheless, even fuzzy disclosure faces significant obstacles to effective implementation. As I describe in Part VI, other countervailing cognitive, motivational, and social factors could prevent or impair the operation of the three disclosure mechanisms in the fuzzy disclosure context.

All this talk of the limitations of binary and fuzzy disclosure is not intended to undermine the value of disclosure as a regulatory tool.

Disclosure can be an effective instrument for regulators seeking to influence the behavior of law-abiding yet strategic firms and individuals. The reflexive mechanism of disclosure can reinforce their normative commitment to comply with the underlying substantive law. Likewise, their normative commitment to abide by disclosure obligations drives the deterrent and enhancement mechanisms, which bring external pressures to comply with the underlying substantive law. Yet if regulators hope to rely upon norms of "law-abidingness" in these ways, they must design their disclosure regimes more carefully. In particular, they must take into account the very ambiguity they seek to overcome and recognize the cognitive and social influences that affect the operation of those disclosure regimes.

II. AMBIGUITY, NORMS, AND STRATEGIC NONCOMPLIANCE

Before turning to the theory of mandatory disclosure in Part III, I want to identify and describe three assumptions that govern the discussion in the remainder of this Article. The first, I expect, is fairly noncontroversial: the law is ambiguous. The second is open to more debate: generally speaking, firm managers are law-abiding but strategic actors, or what I call "good-faith actors." The third ties the first two together: under conditions of ambiguity, good-faith actors will engage in what I call "strategic noncompliance."

A. Regulation and Ambiguity

Few readers will be shocked by the proposition that laws and regulations are ambiguous. Indeed, identifying and lambasting ambiguity in the law has become a bit of a national pastime among critics of traditional regulation.[2] Accordingly, I will spend little ink or time providing support for the claim. Suffice it to be said that environmental laws and regulations can be quite complicated, often having highly technical core requirements ringed with interlocking definitions and exceptions.[3] For example, one court described analysis of the federal hazardous waste statute as "a mind-numbing journey."[4] Yet as complex as environmental regulations (such as the Clean Air Act's air toxics rules) can be, compared to the federal tax regulations they seem as sophisticated as Forrest Gump. One has only to spend a

2. *See* Richard J. Lazarus, *Meeting the Demands of Integration in the Evolution of Environmental Law: Reforming Environmental Criminal Law*, 83 GEO. L.J. 2407, 2429-39 (1995); David B. Spence, *The Shadow of the Rational Polluter: Rethinking the Role of Rational Actor Models in Environmental Law*, 89 CAL. L. REV. 917, 931-36, 960 (2001) (surveying the "complexity critique" of command-and-control regulation).

3. *See* Robert F. Blomquist, *"Clean New World": Toward an Intellectual History of American Environmental Law, 1961-1990*, 25 VAL. U. L. REV. 1, 4-9 (1990); Peter H. Schuck, *Legal Complexity: Some Causes, Consequences, and Cures*, 42 DUKE L.J. 1 (1992).

4. *See* Am. Mining Cong. v. EPA, 824 F.2d 1177, 1189 (1987).

bit of time working with the consolidated returns rules or partnership regulations to appreciate the astounding intricacy of those programs.[5]

Of course, complexity is not synonymous with ambiguity;[6] it is not even a necessary condition for ambiguity.[7] Take the definition of "solid waste" under the Resource Conservation and Recovery Act[8] or the concept of "income" under the Internal Revenue Code.[9] The fact is, though, that complexity often leads to ambiguity, as each word or concept added to a regulation to clarify it brings along the potential for additional alternative readings and unintended consequences. This notion lies at the core of Bayless Manning's concept of "hyperlexis," defined as ungoverned elaboration of regulations.[10] Whether it arises from the vagueness of a single term (either on its face or as applied) or from the uncertainty generated from a complex system of rules, definitions, and exceptions, some amount of ambiguity appears inevitable and, thus, unsurprising.

What is surprising is how little attention is paid in the compliance literature to the strategic use of ambiguity by regulated entities, with the exception of the tax compliance literature.[11] Many discussions of

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5. *See* James S. Eustice, *Tax Complexity and the Tax Practitioner*, 45 TAX L. REV. 7, 7-9 (1989); Matthew B. Krasner, *Continuation of the Affiliated Group Subsequent to a Divisive Reorganization: A Patchwork of Inconsistent Rules with Uncertain Application*, 41 VAND. L. REV. 283 (1988).

6. *See, e.g.,* Lazarus, *supra* note 2, at 2428-40 (defining complexity to include technicality, indeterminacy, obscurity, and differentiation); Schuck, *supra* note 3, at 3 (defining complexity to include density, technicality, differentiation, and indeterminacy (or uncertainty)).

7. Legal scholars have struggled to define the meaning and importance of ambiguity itself. *See* Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65, 66 (1983) (noting that commentators "differ considerably in both the relative significance they attach to formal rules and the attributes of rules with which they are most concerned"). Diver focuses on the concept of precision, positing that it is a trade-off between three elements: transparency, accessibility, and congruence. *Id.* at 67. Lazarus refers to "indeterminate" rules, under which outcomes are often difficult to predict due to ambiguity in their language. Lazarus, *supra* note 2, at 2431.

8. Solid waste is defined as "any garbage, refuse, sludge from a waste treatment plant, water supply treatment plant, or air pollution control facility and other discarded material." 42 U.S.C. § 6903(27) (2000).

9. *See* I.R.C. § 61(a) (2000) (defining gross income as "all income from whatever source derived").

10. Bayless Manning, *Hyperlexis and the Law of Conservation of Ambiguity: Thoughts on Section 385*, 36 TAX LAW. 9, 12 (1982). Manning defined it more colorfully as "the pathological social condition caused by an overactive law-making gland." Bayless Manning, *Hyperlexis: Our National Disease*, 71 NW. U. L. REV. 767, 767 (1977); *see also* Robert Charles Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L.J. 90, 97-130 (1977) (tracking the evolution of Subchapter C as a series of strategic moves and countermoves by government and taxpayers).

11. *See* Paul J. Beck et al., *Taxpayer Disclosure and Penalty Laws*, 2 J. PUB. ECON. THEORY 243 (2000); Andrew D. Cuccia, *The Economics of Tax Compliance: What Do We Know and Where Do We Go?*, 13 J. ACCT. LITERATURE 81, 89 (1994) (surveying the tax literature on uncertainty in law).

compliance and enforcement assume that the difference between compliance and violation in any given situation is obvious.[12] Others focus on violations of very simple rules and laws that have minimal ambiguity, such as running stop lights, shoplifting, fishing in prohibited areas, and the like.[13] Still others acknowledge ambiguity, but treat it solely as a barrier to compliance, suggesting that firms would comply if only someone would tell them what the rule "actually" is.[14] Undoubtedly, ambiguous rules can breed confusion among uninitiated and inexperienced actors,[15] but they also provide possibilities for the knowledgeable, strategic actor.[16] I build upon that concept and import it into the study of mandatory disclosure more generally.

B. The Good-Faith, Strategic Actor

My second governing assumption is that firm actors attempt in good faith to comply with the law. Much of the traditional compliance literature assumed that individuals and firms are rational actors, driven solely or primarily by the desire to maximize profit.[17] More recently, many commentators and policymakers have rejected the dominance of the rational-actor stance, subscribing to the view that people comply with the law because of a widely held norm of law-abidingness.[18] There is significant empirical support for this notion of a "compliance norm" in a variety of settings, including business settings.[19] Rather than replacing economic rationality as an explanation

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12. Lauren B. Edelman et al., *Legal Ambiguity and the Politics of Compliance: Affirmative Action Officers' Dilemma*, 13 LAW & POL'Y 73, 74 (1991) ("Much of the regulation literature treats law as a clear mandate to which organizations either comply or fail to comply.").

13. *See* TOM R. TYLER, WHY PEOPLE OBEY THE LAW 41 (1990) (focusing on shoplifting, traffic violations, and drunk driving); K. Kuperan & Jon G. Sutinen, *Blue Water Crime: Deterrence, Legitimacy, and Compliance in Fisheries*, 32 LAW & SOC'Y REV. 309, 312 (1998) (examining violations of fishery regulations, in part because of their relative lack of ambiguity).

14. *See* Spence, *supra* note 2, at 977.

15. *See* JAMES K. HAMMITT & PETER REUTER, RAND. CORP., PUB. NO. R-3657-EPA/JMO, MEASURING AND DETERRING ILLEGAL DISPOSAL OF HAZARDOUS WASTE: A PRELIMINARY ASSESSMENT 7-9 (1988) (observing that noncompliance can be related to knowledge of regulations and technical expertise); John Brehm & James T. Hamilton, *Noncompliance in Environmental Reporting: Are Violators Ignorant, or Evasive, of the Law?*, 40 AM. J. POL. SCI. 444 (1996); Laura Langbein & Cornelius M. Kerwin, *Implementation, Negotiation and Compliance in Environmental and Safety Regulation*, 47 J. POL. 854, 860 (1985).

16. *See* Richard G. Stoll, *Coping with the RCRA Hazardous Waste System: A Few Practical Points for Fun and Profit*, 1 ENVTL. HAZARDS 6, 6 (1989) ("In some situations, however, happy results and great cost savings can be achieved through a more careful reading of EPA's regulations, an awareness of EPA's rulings (often unpublished) and creative thinking.").

17. Timothy F. Malloy, *Regulation, Compliance and the Firm*, 76 TEMP. L. REV. 451, 461-63 (2003).

18. *Id.* at 464-75.

19. *Id.*

(or predictor) of behavior, the compliance norm takes a place beside it as an additional factor influencing behavior.[20]

For purposes of this Article, I put consideration of economic rationality slightly off to the side (although not completely out of the picture). Instead, I aim to sharpen our understanding of what it means to follow the compliance norm. While my law-abiding actor experiences a strong normative drive to comply with the law,[21] that drive is tempered by at least two other factors. First, the law-abiding actor balances the compliance norm against other norms that influence behavior, including organizational norms enforced within the firm.[22] Second, within the broad constraint of following the law, the normative actor will behave strategically, searching for options that will advance his interests and anticipating likely reactions of other concerned parties. Combine these two factors in an environment of ambiguous regulation, and the result is what I call "strategic noncompliance."

Strategic noncompliance occurs where the firm acts in accordance with an interpretation of an ambiguous regulation that conflicts with the regulator's interpretation.[23] The concept of strategic noncompli-

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20. IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE 31 (1992); Malloy, *supra* note 17, at 456. Various scholars have begun to develop theories as to how these two behavioral influences interact, although there is no clear consensus on the precise relationship between the two. *See id.* at 456 n.17.

21. Norms scholars in several disciplines continue to debate the underlying factors that drive norm compliance. For many law and norms scholars and others, the normative actor engages in an instrumental comparison of the costs and benefits of complying with a social norm. The detriments associated with transgressing a norm can include social and psychological sanctions, including disapproval by peers and feelings of embarrassment and guilt. *See, e.g.*, JON ELSTER, THE CEMENT OF OUR SOCIETY: A STUDY OF SOCIAL ORDER 106 (1989) ("Alternatively, self-interest may act as a constraint on norms: I do *X* provided that the costs—the direct costs of doing *X* and the opportunity costs of not doing *Y*—are below a certain level."); Christine Horne, *Sociological Perspectives on the Emergence of Social Norms*, *in* SOCIAL NORMS 3, 4 (Michael Hechter & Karl-Dieter Opp eds., 2001) (observing that "the majority of scholars emphasize the role of external sanctions"); Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338, 340, 378-81 (1997) (discussing the controversy over external social sanctions and internalization). Others contend that norms have been "internalized" and thus operate without regard to external or internal sanctions. *See* JOHN FINLEY SCOTT, INTERNALIZATION OF NORMS: A SOCIOLOGICAL THEORY OF MORAL COMMITMENT 1-4 (1971); Horne, *supra*, at 4 (defining internalization to include situations in which individuals "follow social norms because they want to"); Mark C. Suchman, *On Beyond Interest: Rational, Normative and Cognitive Perspectives in the Social Scientific Study of Law*, 1997 WIS. L. REV. 475, 480-82.

22. ELSTER, *supra* note 21, at 104; Robert E. Scott, *The Limits of Behavioral Theories of Law and Social Norms*, 86 VA. L. REV. 1603, 1611 (2000).

23. Strategic noncompliance is commonly seen in the tax area. *See* Michael J. Graetz & Louis L. Wilde, *The Economics of Tax Compliance: Fact and Fantasy*, 38 NAT'L TAX J. 355, 357 (1985) (characterizing "tax understatements from taking advantage of factual and legal uncertainties about the application of the substantive tax law" as noncompliance); Doreen McBarnet, *The Construction of Compliance and the Challenge for Control: The Limits of Noncompliance Research*, *in* WHY PEOPLE PAY TAXES 333, 341 (Joel Slemrod ed., 1992) ("Law should be seen as a raw material to be worked on, and, in tax avoidance, what

ance acknowledges that in the case of ambiguous regulations, a firm's compliance status is indeterminate, at least until some arbiter (such as a court) issues a final pronouncement. In some cases of strategic noncompliance, the firm's reading of the regulation may be very well supported, while in others it may be simply a reasonable alternative or even a strained interpretation. Strategic noncompliance is conceptually distinct from "regulatory arbitrage," a practice in which parties structure activity (such as business transactions or financial instruments) so as to avoid the application of regulation or reduce its costs.[24] In regulatory arbitrage, also known as "line-walking," the regulation is relatively clear, and the party uses that clarity to arrange its affairs to stay just beyond the reach of the regulation.[25] Perhaps the best example of line-walking is the use of tax shelters, which take advantage of complications in the tax code and regulations to create tax benefits that neither Congress nor the Treasury Department would have intended or desired.[26] In practice, whether a firm is engaged in strategic noncompliance or regulatory arbitrage often depends on one's judgment as to whether the regulation in question is ambiguous or not.[27]

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we are seeing is tax practitioners working on the law to . . . create legal advantages for their clients that were not necessarily intended." (footnote omitted)). It also occurs in the environmental area. For example, in the late 1990s, the EPA entered into a series of consent decrees with a group of diesel truck manufacturers settling claims under the Clean Air Act involving allegations that the defendants equipped their trucks with "defeat devices." Defeat devices are designed to control various functions within the engine such that the engine automatically operates in one mode while undergoing federally required emissions testing and operates in another, more highly polluting mode in actual use on the highway. Naftali Bendavid, *Penalty for Truck Pollution: $1 Billion*, CHI. TRIB., Oct. 23, 1998, at 4. The manufacturers contended that it was not their fault that the EPA's emission tests did "not capture the full effect of trucks cruising at highway speeds." John H. Cushman Jr., *Makers of Diesel Truck Engines Are Under Pollution Inquiry*, N.Y. TIMES, Feb. 11, 1998, at A16.

24. *See* Frank Partnoy, *Financial Derivatives and the Costs of Regulatory Arbitrage*, 22 J. CORP. L. 211, 227 (1997); Cass R. Sunstein, *Problems with Rules*, 83 CAL. L. REV. 953, 995 (1995) ("Because rules have clear edges, they allow people to 'evade' them by engaging in conduct that is technically exempted but that creates the same or analogous harms.").

25. Edward D. Kleinbard, *Corporate Tax Shelters and Corporate Tax Management*, 1999 TAX EXECUTIVE 235, 241 (describing line-walking as a practice in which "taxpayers go to the edge of whatever activity is permitted by formal rules," which is viewed by Treasury officials as "troublesome").

26. *See* MARK KELMAN, A GUIDE TO CRITICAL LEGAL STUDIES 41 (1987) (describing how sophisticated syndicates of physicians formed a cattle-feeding shelter to take advantage of a provision allowing farmers to immediately "deduct feed costs . . . on the theory that it would simplify bookkeeping for financially unsophisticated operators"); *see also* Henry T.C. Hu, *Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. PA. L. REV. 333, 398 (1989) (noting a similar problem of line-walking with respect to international regulation of new generations of financial products such as the interest rate swap and the currency swap).

27. That judgment can have great significance in the context of an enforcement action in which the court will defer to the regulator's reading of an ambiguous regulation but not to its interpretation of a "clear" regulation. In those circumstances, strategic noncompliance will often be converted into a judgment of liability, while regulatory arbitrage may

The key to the relationship between the compliance norm and strategic noncompliance lies in the fact that in most cases regulations are neither perfectly clear nor hopelessly indeterminate. It helps to think of regulations as having a range of potential interpretations of varying degrees of reasonableness, rather than one "true" interpretation or an infinite set of possible meanings.[28] At either end of the range, the interpretations begin to become more and more unreasonable, eventually reaching the point at which they are frivolous. One can accept the inherent ambiguity and open texture of rules yet still recognize that even complex and vague rule language can have a widely accepted, finite set of potential meanings. Within the discrete communities affected by or working with the rule, there is likely to be a sense of general agreement as to the relative reasonableness of various alternative interpretations: some of those alternatives will fall within the zone of reasonableness and others will not.[29] Strategic noncompliance occurs where the regulator chooses one interpretation, and the firm manager selects another within that zone of reasonableness.

One might argue that strategic noncompliance of this sort is not objectionable. To a certain extent, our legal system encourages, or at least tolerates, efforts by citizens to make the most of opportunities present in regulations and laws for minimizing the impact of the law on business or personal activities[30] and to question or challenge agen-

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emerge with the court's (sometimes grudging) blessing.

28. Of course, some language may have a smaller range of potential meanings due to the use of words or terms with generally accepted meanings. For example, a rule that provides that no person may pilot a commercial airliner after his sixtieth birthday has a much narrower range of meanings than one that prohibits flying where the person "poses an unreasonable risk of an accident." Diver, *supra* note 7, at 69. Diver referred to this quality as the "transparency" of the rule. *Id.* at 67.

29. *See id.* at 67 n.14 ("I assume, at a minimum, that the addressees of most administrative rules are a 'community' whose shared experiences or values can give objective (if not wholly deterministic) meaning to such texts."); Sunstein, *supra* note 24, at 990 ("Almost all real-world cases involving the meaning of rules are very easy. Although they are contestable, the *ex post* substantive judgments that underlie readings of rules are often widely shared . . . ."). For some rules, that meaning is borne of general practice, custom, and socialization and embedded in mental models shared by members of the relevant professions. *See* Lynn M. LoPucki, *Legal Culture, Legal Strategy, and the Law in Lawyers' Heads*, 90 NW. U. L. REV. 1498, 1516-21 (1996) (discussing the development of mental models of the law among practitioners and judges who interact on a regular basis); Doreen McBarnet & Christopher Whelan, *The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control*, 54 MOD. L. REV. 848, 872-73 (1991) (discussing "working certainty" that can sometimes be achieved). Of course, there may be disagreement as to the relative reasonableness of those alternatives within the zone, as well as to the reasonableness of some interpretations at the margins.

30. Judge Learned Hand's perspective on tax planning, for instance, is well known to most tax lawyers and law students taking the basic tax course: "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935). Almost

cies' interpretations of statutes and regulations.[31] The enforcement process could thus be viewed as a vehicle by which ambiguities and good-faith disagreements about the meaning of the law are resolved.[32] Enforcement is thus viewed as part of rulemaking, in which content is determined by a judge or by the parties in negotiation.

In a world of perfect information and zero transaction costs, such an argument might well have traction. In the actual world of regulation, however, reliance on standard enforcement practices such as inspections and fines is a dubious proposition. This is so because strategic noncompliance often occurs deep in the belly of the firm and is often invisible to the regulatory agency.[33] Absent meaningful disclosure, an internal firm determination concluding that a process change falls within an exception or that a waste product is not subject to regulation will never be submitted to or reviewed by a regulator. Such determinations often require extensive knowledge of facility operations and access to numerous and diverse documents and personnel. The costs to the government of identifying and obtaining that information to conduct its own evaluations would be prohibitive. Consequently, unless the regulator implements some workable form of disclosure, many acts of strategic noncompliance can remain in the shadows, and as a practical matter, the underlying ambiguities are resolved in favor of the firm. This brings us back to the questions this Article attempts to address: Do disclosure mechanisms shine a light on strategic noncompliance, and if so, to what effect?

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seventy years later, Hand's pronouncement continues to influence courts in their analysis of tax planning activities. *See, e.g.*, Winn-Dixie Stores, Inc. v. Comm'r, 254 F.3d 1313, 1316 (11th Cir. 2001); IES Indus., Inc. v. United States, 253 F.3d 350, 354-55 (8th Cir. 2001). For a criticism of the conventional view that taxpayers have a "right" to engage in tax planning, see David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 220-22 (2002).

31. The federal Administrative Procedure Act and many federal laws recognize the right of interested parties to seek judicial review of newly promulgated regulations. *See, e.g.*, Administrative Procedure Act, 5 U.S.C. §§ 701-706 (2000); Resource Conservation and Recovery Act, 42 U.S.C. § 6976 (2000).

32. *See* Bridget M. Hutter, *Controlling Workplace Deviance: State Regulation of Occupational Health and Safety*, *in* DEVIANCE IN THE WORKPLACE 191, 202-04 (Ida Harper Simpson & Richard L. Simpson eds., 1999) (describing compliance as a process which includes enforcement and negotiation as tools to clarify vague or ambiguous rules); JOSEPH F. DIMENTO, ENVIRONMENTAL LAW AND AMERICAN BUSINESS: DILEMMAS OF COMPLIANCE 25-28 (1986) (discussing compliance as a process of interpretation).

33. *See* McBarnet, *supra* note 23, at 340.

> If challenged they might fail; the enforcers' definition of the meaning or applicability of legal rules might prevail. But one point of the strategy was that the transaction, in its endorsed-by-lawyers form, could be treated by the taxpayer as not taxable. It might, therefore, be not declared at all, or not in a recognizably taxable form. The revenue department might never have the opportunity to challenge.

Id.

III. MANDATORY DISCLOSURE: THE BACK STORY

This Part provides a bit of background on disclosure as a regulatory tool. It examines the goals and operation of typical mandatory disclosure systems and identifies three common mechanisms of most systems. The Part concludes with an introduction to two different forms of disclosure: binary and fuzzy.

A. Types of Mandatory Disclosure

Legislators and government agencies use various forms of mandatory disclosure to regulate a wide assortment of activities, including securities transactions, corporate governance, provision of health care, emission of pollutants, payment of taxes, and so on. In this Article, I focus on "complementary disclosure," meaning disclosure used to directly support the enforcement of other substantive regulations. Thus, when I receive a payment from a third party, various substantive provisions of the Internal Revenue Code (IRC) may characterize that payment as income and subject me to tax. Other provisions of the IRC require me (and, in some cases, the payor) to disclose information about the payment to the government. These two sets of provisions work together to ensure that revenue is collected.[34]

The other two types of disclosure—primary and supplemental—receive much more attention in the literature. Disclosure is "primary" where it is the dominant regulatory tool used to implement a policy goal or goals. For example, federal regulation of the issuance of publicly traded securities relies upon primary disclosure. It requires that firms disseminate specified information about the securities and the issuer to potential purchasers and to the market generally.[35] Supplemental disclosure augments the goals of existing substantive rules without assisting in their enforcement. For example, under the Clean Air Act's air toxics program, the EPA sets emission limits for a set of chemicals known as "hazardous air pollutants," or "HAPs."[36] Separately, the EPA's Toxic Release Inventory (TRI) program requires firms to disclose the volume and nature of discharges of specified pollutants (including many HAPs) on an annual basis.[37] While both programs seek to reduce emissions of HAPs and thus supple-

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34. *See* I.R.C. § 6051(a), (d) (2000) (requiring businesses to report to the government wages paid to employees).

35. Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 764 (1995); Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 418 (2003); Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1207-09 (1999).

36. 42 U.S.C. § 7412(d) (2000).

37. *Id.*

ment each other's efforts, they do so by employing largely unrelated mechanisms.

All three forms of disclosure are obviously intended to address some type of information deficit. Typically, that deficit occurs because the regulated firm has information regarding its operations not otherwise available to the government or some relevant third party.[38] For example, in the RBS Industries scenerio,[39] Kay Burde has private information regarding the nature of the process changes, information that the government would like to acquire. In the securities context, the Securities and Exchange Commission's disclosure rules for the issuance of securities seek to minimize the disparity of information between firm managers and the public market.[40]

While curing information disparities is a central part of mandatory disclosure, it is not an end in itself. Rather, regulators view the information asymmetries as barriers that prevent the firm from adopting the behavior desired by the regulator.[41] To that end, most disclosure regimes exhibit a similar structure, set out in Figure 1, in which a sequence of four steps leads from the initial state of information asymmetry to the regulator's ultimate goal.[42] First, the firm is required to engage in the collection and processing of private information. This processing may involve anything from simple tabulation of the data to sophisticated legal, factual, and scientific analysis and evaluation. Thereafter, the processed information is disclosed to the relevant recipients. (In the case of complementary disclosure, the recipients are primarily government regulators, although environmental and community groups and the media may also ultimately obtain the information.) In the next step, the recipients themselves process the information and determine whether to take action—including enforcement actions or publicity campaigns—in light of it. Lastly, assuming the recipient does take some effective action in response to the disclosure, the firm may modify its behavior accordingly.

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38. But the information deficit addressed by mandatory disclosure may also be found inside the regulated firm. In some cases, certain individuals or organizational units within the firm may have access to information needed by others within the firm. Thus, some mandatory disclosure programs require the firm to have a system in place for the collection and reporting of internal information to firm managers to be used by those managers for their own use or for preparing external disclosures.

39. *See supra* Part I.

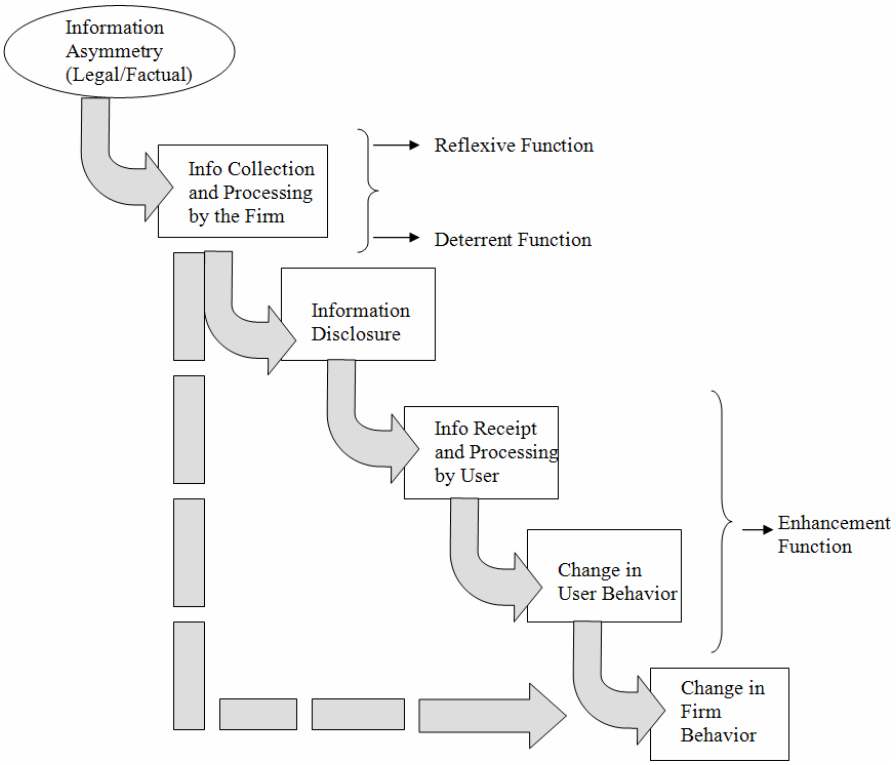
40. *See* Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What You Measure*, 96 COLUM. L. REV. 1335, 1335-37 (1996); Kitch, *supra* note 35, at 773-76.

41. *See* Paredes, *supra* note 35, at 418.

42. This figure is based on a flowchart in DAVID WEIL, THE BENEFITS AND COSTS OF TRANSPARENCY: A MODEL OF DISCLOSURE BASED REGULATION 34 (Boston Univ. Sch. of Mgmt., Working Paper No. 2004-12, 2004).

FIGURE 1

MANDATORY DISCLOSURE:
FORM AND FUNCTION



As the flowchart in Figure 1 illustrates, the ultimate goal of a complementary disclosure regime is to alter the behavior of the firm. Such disclosure regimes tend to rely on three mechanisms or functions, either separately or in combination, to influence firm behavior: the reflexive mechanism, the deterrent mechanism, and the enhancement mechanism. As indicated in Figure 1, they operate at various stages of the disclosure process.[43] Because I use these three mechanisms as a basis for evaluating different forms of disclosure in Parts IV and V, it is helpful to have an understanding of each.

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43. Of course, various types of disclosure programs may have a wide variety of goals and functions beyond those I discuss here. *See, e.g.*, WEIL, *supra* note 42, at 3-6 (identifying allocative efficiency, equity, civic engagement, and performance improvement); Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1048 (1995) (designed to overcome agency problems); William M. Sage, *Regulating Through Information: Disclosure Laws and American Health Care*, 99 COLUM. L. REV. 1701 (1999) (describing five rationales for disclosure in the health care industry, including competition, productivity, and democracy rationales).

1. Information and the Reflexive Mechanism

The reflexive mechanism focuses on information asymmetries within the firm that impair the firm's ability to identify and respond to important issues. Where the firm's information collection, processing, or communication routines are flawed, information that should be flowing to other firm departments can end up in a "traffic jam" or a dead end. Consider the role of corporate directors in ensuring that the firm operates in compliance with the law. The information required to determine whether an oil refinery is violating a specific environmental regulation may be dispersed among two or more individuals or units within the firm. Absent some mechanism that coordinates the collection and processing of that information, the firm will be unable to assess its compliance status and, if necessary, alter its internal operating routines to improve environmental performance. Even among firms with a sincere desire to comply with or even exceed the substantive regulatory requirements, organizational inertia flowing from flawed operating procedures, inadequate resources, opportunistic managers, or other factors can stand in the way of developing such a mechanism.[44]

A legal obligation to collect, process, and disclose information to parties within the firm or outside of it can encourage the firm to become more aware of its own internal structure and operations and perhaps even self-critical of its performance. This is the reflexive mechanism of disclosure. As described by Eric Orts, reflexive regulation encourages "internal self-critical reflection" within organizations and institutions concerning the nature and consequences of their activities.[45] The engine driving reflexive regulation is process; that is, the development of mandatory procedures that by their nature force the firm to confront the substantive issues of concern to the regulator in a systematic way.[46]

One can see reflexive systems in operation in a variety of circumstances. For example, the United States Sentencing Guidelines for business organizations provide firms with a strong incentive to implement internal compliance-monitoring programs.[47] A firm facing criminal penalties can obtain a significant penalty reduction if it had in place a bona fide compliance system meeting certain general criteria.[48] Likewise, under Delaware corporate law, as interpreted in the

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44. Malloy, *supra* note 17, at 484-91.

45. Eric W. Orts, *Reflexive Environmental Law*, 89 NW. U. L. REV. 1227, 1254-55 (1995).

46. Malloy, *supra* note 17, at 495.

47. Orts, *supra* note 45, at 1281-82.

48. U.S. SENTENCING GUIDELINES MANUAL § 8C2.5(f) (2004). The U.S. Sentencing Commission was established under the Sentencing Reform Act of 1984. *See id.* § 1A2. The Commission issued sentencing guidelines effective in 1987 for individuals, followed by

Caremark decision, directors have a duty to employ an internal reporting system aimed at channeling information about the firm's compliance status to senior management and the board.[49] In the tax area, Congress adopted a reflexive approach in section 6662(e) of the Internal Revenue Code,[50] which provides for relief from penalties imposed on a firm that understates the value of certain transactions with affiliated companies where the firm develops and maintains contemporaneous documentation supporting the determination and reasonableness of its transfer prices.

There is significant controversy over whether various forms of monitoring and disclosure systems actually achieve their reflexive goals. Many scholars are skeptical, noting the lack of evidence supporting the efficacy of such programs or relying on economic analysis or social science research to identify likely barriers to successful implementation.[51] However, there is at least some evidence that in some circumstances, such programs have caused firms to critically examine their internal policies.[52] For example, in an evaluation of the section 6662(e) penalty reduction program based on a survey of 696 taxpayers and on-site examinations of twenty-five multinational corporations, the Internal Revenue Service concluded, "the preparation of contemporaneous documentation leads taxpayers to perform more

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amendments effective in 1991 that cover sentences for organizations. *See id.* The guidelines set forth seven general criteria that must be met in order to obtain a sentencing reduction, including establishing standards and procedures reasonably capable of reducing the prospect of criminal conduct, appointing a high-level compliance officer, training employees, using monitoring and auditing systems to assure adherence to the program, and modifying the program when noncompliance is identified. *See id.* §§ 8B2.1(b)(1)-(7). In a recent decision, the United States Supreme Court held the mandatory nature of the sentencing guidelines rendered them unconstitutional. United States v. Booker, 123 S. Ct. 738 (2005).

49. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996). It is important to note that *Caremark* requires only good-faith efforts to meet the duty. *Id.* Conceivably, directors acting in good faith could nonetheless establish a minimal or flawed system, yet still meet the duty to monitor, particularly where they relied upon trusted, qualified corporate staff or outside experts to design the system.

50. I.R.C. § 6662(e)(3)(B) (2000).

51. *See* RICHARD S. GRUNER, CORPORATE CRIME AND SENTENCING 867-83 (1994); Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487, 510-15 (2003); William S. Laufer, *Corporate Liability, Risk Shifting, and the Paradox of Compliance*, 52 VAND. L. REV. 1343, 1407-10 (1999) (suggesting that corporate monitoring and compliance systems can be used to create a false image of "good corporate citizenship" and to reduce the likelihood of criminal prosecution and the severity of penalties).

52. *See* John R. Steer, *Changing Organizational Behavior—The Federal Sentencing Guidelines Experiment Begins to Bear Fruit*, *in* 1 CORPORATE COMPLIANCE 2002, at 113, 116-17 (PLI Corporate Law & Practice Course, Handbook Series No. B-1317, 2002); *see also* INTERNAL REVENUE SERV., EFFECTIVENESS OF INTERNAL REVENUE CODE SECTION 6662(e) (2001) [hereinafter SECTION 6662 STUDY].

comprehensive up-front analysis of transfer prices, and thereby reduces the number of disputes in this area."[53]

Clearly, whether a particular program will serve the reflexive mechanism depends on a variety of contextual factors, including the specific design of the program and the nature of the firms regulated.[54] I propose no resolution of this question here, even assuming that it is capable of resolution, but do offer this point for consideration. In thinking about the reflexive mechanism, it is useful to distinguish between two causes of noncompliance. Where noncompliance flows primarily from structural features of the firm such as poorly designed communication and coordination channels between organizational units, process-oriented regulation may be quite successful in facilitating review-and-adjustment internal operating procedures.[55] However, where violations result from the choice to play the audit lottery or to engage in strategic noncompliance, process-oriented regulation is likely to be less successful and may be utilized as a defensive tool to protect the firm.[56] I develop this point in more detail below.[57]

2. Response and the Enhancement Mechanism

This mechanism of disclosure focuses more directly on how mandatory disclosure affects the behavior of the recipient of information. The enhancement mechanism is premised upon the assumption that access to more accurate or better-quality information will enhance the behavior of the recipient. The securities field provides a useful and (depending upon your perspective) persuasive demonstration of the enhancement mechanism. First, based on the assumption that well-informed investors can protect themselves by "voting with their feet," our securities laws require the production of an enormous amount of internal information aimed at providing investors with an adequate basis for judging the value of the offered securities. On a related note, comprehensive disclosure also purportedly improves the

53. SECTION 6662 STUDY, *supra* note 52, at 7.

54. For example, has firm management embraced an incentive structure that encourages self-reflective behavior among employees?

55. *See* Malloy, *supra* note 17, at 494-95.

56. *See id.* at 524; Orts, *supra* note 45, at 1283-84.

57. *See infra* Part IV.C. One last note concerning the reflexive function is that at the individual level it may serve a second, related purpose by creating a sense of accountability. Psychologists define accountability as the expectation that one's decisions and actions will be subject to scrutiny by others. Philip E. Tetlock, *The Impact of Accountability on Judgment and Choice: Toward a Social Contingency Model*, *in* 25 ADVANCES IN EXPERIMENTAL SOCIAL PSYCHOLOGY 331, 337 (Mark P. Zanna ed., 1992). In a series of experimental laboratory studies, researchers have explored the behavioral responses of individuals under conditions of accountability. I address this point in more detail in the discussion of the reflexive function in binary disclosure. *See infra* Part IV.D.

market's ability to set prices.[58] Second, disclosure promotes shareholder empowerment by providing shareholders with the information needed to exercise their franchise rights and, when necessary, to pursue litigation against the firm or its managers and directors.[59] While there is still debate about the actual value of the enhancement mechanism in the securities area,[60] there is little question that federal legislators and regulators see it as the dominant strategy.[61]

Disclosure regimes relying upon the enhancement mechanism are widely used.[62] However, apart from the emerging literature on tax shelter disclosures,[63] most discussion of the enhancement mechanism focuses on private-party recipients, such as local communities, customers, stockholders, and nongovernmental organizations.[64] Generally speaking, disclosure for private-party consumption strives to bring market forces and public opinion to bear on firm decisionmaking, thus altering firm behavior without the need for direct, coercive government action.[65] Yet, information disclosure can also improve the government regulator's operations in at least two ways. First, assuming that the regulator receives accurate and complete information about firm practices, it can adjust its enforcement activities so as to identify and pursue violations at one plant or within an entire industry sector that otherwise would be difficult to detect.[66] Second, the

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58. *See* Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977, 979 (1992); Kitch, *supra* note 35, at 764-65; Paredes, *supra* note 35, at 418. For an overview and critique of the efficient capital market hypothesis, see Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613 (1988).

59. *See* Mahoney, *supra* note 43, at 1051-52.

60. For a concise overview of the historical and current debates, see Paredes, *supra* note 35.

61. *Id.* at 421-30.

62. *See, e.g.*, Tom Tietenberg, *Disclosure Strategies for Pollution Control*, *in* THE MARKET AND THE ENVIRONMENT: THE EFFECTIVENESS OF MARKET-BASED POLICY INSTRUMENTS FOR ENVIRONMENTAL REFORM 14 (Thomas Sterner ed., 1999); WEIL, *supra* note 42, at 1-2.

63. *See, e.g.*, STAFF OF JOINT COMM. ON TAXATION, 106TH. CONG., STUDY OF PRESENT-LAW PENALTY AND INTEREST PROVISIONS AS REQUIRED BY SECTION 3801 OF THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998 (INCLUDING PROVISIONS RELATING TO CORPORATE TAX SHELTERS) 157 (Comm. Print 1999) [hereinafter PENALTY PROVISIONS]; U.S. DEP'T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS 36-39 (1999); *Symposium on Corporate Tax Shelters Part I*, 55 TAX L. REV. 125 (2002); *Symposium on Corporate Tax Shelters Part II*, 55 TAX L. REV. 289 (2002).

64. *See, e.g.*, Tietenberg, *supra* note 62, at 18-23; Paul R. Kleindorfer & Eric W. Orts, *Informational Regulation of Environmental Risks*, 18 RISK ANALYSIS 155, 160 (1998); Williams, *supra* note 35, at 1277-84 (arguing that the Securities and Exchange Commission has the legal authority to require disclosure of compliance information for the benefit of investors).

65. Tietenberg, *supra* note 62, at 15; Mark A. Cohen, *Information as a Policy Instrument in Protecting the Environment: What Have We Learned?*, 31 ENVTL. L. REP. NEWS & ANALYSIS 10425, 10425-26 (2001); Kleindorfer & Orts, *supra* note 64, at 156-59.

66. Professor Pearlman characterizes this as the "audit" function. Ronald A.

regulator may use the information to identify flaws or ambiguities in the underlying regulations and attempt to correct such problems by modifying the rules or issuing informal guidance.[67]

The strength of the enhancement mechanism is subject to two important limitations. First, the firm must provide relevant, usable information in response to the disclosure obligation. Second, the recipient must have the resources needed to process and use the information in a meaningful way. There is a growing literature that examines the latter,[68] and I will not address that point further. However, there is surprisingly little discussion, particularly in the environmental literature, of whether we may reasonably assume that firms will actually comply with mandatory disclosure obligations. Parts IV and V consider that question at length.

3. Disclosure and the Deterrence Mechanism

The deterrence mechanism essentially acts as a bridge between the other two mechanisms. Recall that the reflexive mechanism causes the firm to look inward and engage in a critical, realistic assessment of its own behavior. The enhancement mechanism seeks to alter the information recipient's behavior and thus bring external pressure to bear on the firm. In the deterrence mechanism, the firm anticipates the reaction of information recipients and alters its conduct so as to avoid that reaction.[69]

The deterrence mechanism thus fits neatly within classic rational choice theories of enforcement in which individuals are viewed as rational actors seeking to maximize satisfaction of their preferences.[70]

Pearlman, *Demystifying Disclosure: First Steps*, 55 TAX L. REV. 289, 294 (2002). Access to such information can have impacts beyond simply better enforcement at individual plants. For example, by aggregating the individual disclosures of many plants, the agency is able to identify general trends of noncompliance within an industry sector that can be addressed at that level through a broad-based enforcement initiative or through negotiations with relevant industry associations.

67. In the tax context, Professor Pearlman calls this the "tax policy function." *Id.* at 304.

68. Troy A. Paredes, *Foreword* to Symposium, *After the Sarbanes-Oxley Act: The Future of Mandatory Disclosure System*, 81 WASH. U. L.Q. 229, 237-38.

69. Pearlman, *supra* note 66, at 305 ("If taxpayers realize that the Service will know of the existence of tax shelters in which they participate and, accordingly, will be more likely to audit the transactions, they may be more reluctant to engage in certain transactions in the first place.").

70. *See* Scott, *supra* note 22, at 1613 n.22 (citing HAL R. VARIAN, MICROECONOMIC ANALYSIS 112-20 (3d ed. 1992), to describe rational choice theory); *see also* 2 HERBERT A. SIMON, *Theories of Decision-Making in Economics and Behavioral Science*, *in* MODELS OF BOUNDED RATIONALITY: BEHAVIORAL ECONOMICS AND BUSINESS ORGANIZATION 287, 291 (1982) (describing rational choice as decisionmaking intended to maximize the expected utility of the outcome to the individual, given that individual's preferences). As with most theories, rational choice theory comes in many forms and versions. *See* Timothy F. Malloy, *Regulating by Incentives: Myths, Models, and Micromarkets*, 80 TEX. L. REV. 531, 533 n.9 (2002). For a useful and cogent discussion of subjective expected utility theory, the most

In the case of the business firm, the dominant preference is profit maximization or some other measure of financial success.[71] In deciding whether to engage in a particular activity—be it using a tax shelter mechanism to avoid taxes, generating emissions of a toxic chemical, or using unconventional accounting methods—the firm will weigh the relative costs and benefits of that action. One of the potential costs of the action is "third-party costs": the reaction of third parties such as a regulator seeking penalties, the securities market adjusting share price, or an individual shareholder bringing a lawsuit. The firm will take the action so long as the benefits flowing to it exceed the costs, including third-party costs. Absent a disclosure regime, the relevant third parties may never discover the firm's action, and accordingly the third-party costs are discounted to reflect the low probability of detection.[72] Mandatory disclosure increases the deterrent value of third-party costs by increasing the probability of detection, assuming, of course, that the firm actually makes the disclosure.

B. Binary and Fuzzy Disclosure

Thus far, I have sketched a fairly broad conceptual framework regarding the goals and structure of disclosure regimes. But what do complementary disclosure provisions—those designed to improve compliance with separate, substantive regulations—actually look like on the ground? Of course, they vary along a number of dimensions. For example, some impose an explicit obligation to report the firm's compliance status, while others simply provide "rewards" for voluntary disclosure.[73] Some require that the firm disclose violations immediately or in short order, while others mandate disclosure of noncompliance on an annual or other periodic basis.[74] Given my focus on the effects of ambiguity on disclosure, one other dimension of difference assumes particular prominence, namely the extent to which the

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widely used version of rational choice theory, see Roger G. Noll & James E. Krier, *Some Implications of Cognitive Psychology for Risk Regulation*, 19 J. LEGAL STUD. 747, 750 (1990).

71. *See* DAVID M. KREPS, A COURSE IN MICROECONOMIC THEORY 724-29 (1990) (explaining the rational choice assumption of profit maximization and describing criticisms within economics of that assumption); Herbert A. Simon, *Theories of Decision-Making in Economics and Behavioral Science*, 49 AM. ECON. REV. 253, 262 (1959).

72. Spence, *supra* note 2, at 920-21. In some instances, the nondisclosed information will in due course come to light anyway; thus, the probability of detection is quite high.

73. For example, the EPA provides penalty relief to firms that self-audit and self-report. Jay P. Kesan, *Encouraging Firms to Police Themselves: Strategic Prescriptions to Promote Corporate Self-Auditing*, 2000 U. ILL. L. REV 155, 156.

74. The NSPS notification is required within a short time before the modification is implemented. Conversely, the Clean Air Act's operating permit program for major sources calls for periodic disclosure of noncompliance, usually annually or semiannually. 42 U.S.C. § 7414(a) (2000).

disclosure mechanism acknowledges the ambiguity of the underlying substantive rule. In other words, does the disclosure provision view compliance status as a black-or-white state of affairs (binary view) or, instead, as a gray relationship between an indeterminate standard and an uncertain factual situation (fuzzy view)?[75] This Part uses the two hypothetical scenarios concerning RBS Industries introduced at the start of this Article to highlight the distinction between the binary and the fuzzy view.

1. Binary Disclosure Under the Clean Air Act

When we last met Kay Burde, she was reviewing information regarding changes to one of the older process lines at the RBS Industries plant. During a maintenance turnaround at the plant, the engineering department replaced some of the original pumps and piping with equipment having a larger design capacity. The new pumps and piping increased the efficiency of the unit, allowing it to generate more product in the same amount of time. Burde is concerned because the increased production rate results in slightly higher air emissions, which could mean that the air pollution control requirements under the federal "New Source Performance Standards," or NSPS program, now apply to the plant.

The Clean Air Act's NSPS program seeks to preserve and improve air quality in the face of increasing industrial expansion. It does so by requiring that *new* sources of pollutants in certain industrial or commercial sectors achieve standards of emission control set out in EPA regulations. Thus, if a glass manufacturer were to construct a new steam-generating industrial boiler, it must ensure that its emissions of carbon monoxide, oxides of nitrogen, and other pollutants stay below the specified level. The regulations also apply to existing equipment that undergoes a "modification";[76] and that is the root of Burde's concerns.

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75. "Fuzzy" theory posits that all things are a matter of degree. BART KOSKO, NEURAL NETWORKS AND FUZZY SYSTEMS: A DYNAMICAL SYSTEMS APPROACH TO MACHINE INTELLIGENCE 3 (1992). Thus, rather than being "in compliance" or "out of compliance," a firm would exhibit a greater or lesser degree of compliance. *See id.* at 33 (explaining that a "fuzzy" judge decides a case by applying vague legal principles to uncertain facts); MICHAEL SMITHSON, IGNORANCE AND UNCERTAINTY: EMERGING PARADIGMS 108-18 (1989).

76. If limited to "new" sources only, the NSPS program would create an incentive for cost-conscious companies to maintain older, unregulated equipment for as long as possible, in many cases by making life-extending or capacity-expanding changes and upgrades to the older equipment. Retention of these upgraded "grandfathered" sources with their typically subpar pollution control efficiencies could undercut the balance struck in the NSPS program between economic expansion and pollution reduction. Congress responded to this potential concern by expanding the reach of the NSPS program to include "modifications" to existing sources that result in increased emissions.

The term "modification" is broadly defined to include "any physical or operational change to an existing facility which results in an increase in the emission rate."[77] Recognizing the wide net cast by this definition, the regulations establish a series of exceptions. These exceptions, which include activities such as performance of routine maintenance and repair or improvement of production rate accomplished without capital expenditures, are not considered modifications even if they result in emission increases. From the enforcement perspective, regulators face a significant burden: given the enormous number of facilities out there, how does one identify specific sources that have been modified?[78] Although regulators have the authority to enter and inspect facilities in search of modifications, direct inspection is likely to be neither efficient nor effective. One can easily imagine the enormous difficulties facing the regulator in selecting appropriate target facilities and detecting relevant modifications among numerous boilers, reactors, degreasers, and other potentially regulated equipment within the selected facilities.

Mandatory disclosure is an obvious enforcement tool in such circumstances; the facility itself is in the best position to identify those changes that amount to a modification. In fact, mandatory disclosure is exactly what the EPA chose in these circumstances. Section 60.7(a)(4) of the NSPS regulations sets out a number of notification obligations intended to assist the government in identifying potential violations of the rule.[79] One of those notifications relates to modifications:

> (a) Any owner or operator subject to the provisions of [the NSPS] shall furnish the Administrator written notification . . . as follows:
>
> . . . .
>
> (4) A notification of any physical or operational change to an existing facility which may increase the emission rate of any air pollutant to which a standard applies, *unless that change is specifically exempted* [*from the definition of modification.*][80]

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77. 40 C.F.R. § 60.14(a) (2004).

78. It is estimated that the EPA and its state partners are regulating as many as eight million entities at any given time. Jon D. Silberman, *Does Environmental Deterrence Work? Evidence and Experience Say Yes, but We Need to Understand How and Why,* 30 ENVTL. L. REP. NEWS & ANALYSIS 10523, 10523 (2000).

79. 40 C.F.R. § 60.7(a)(4); *see* Standards of Performance for New Stationary Sources: Modification, Notification, and Reconstruction, 39 Fed. Reg. 36,946, 36,948 (Oct. 15, 1974) (observing that revisions were being proposed "to require source owners or operators to also notify the Administrator . . . prior to the commencement of a potential modification of an existing facility [and that] [s]ection 114 of the Act provides that the Administrator may require such reports 'for the purpose . . . of determining whether any person is in violation of any such standard'").

80. 40 C.F.R. § 60.7(a)(4) (emphasis added).

On its face, the NSPS disclosure asks Burde to answer a rather straightforward question: Did the changes at RBS fall within the listed exceptions or not? There is no doubt that regulators understand that in many cases the question is not so simple. As we will see later in Part IV, due to the ambiguous language of the exceptions and the fact-intensive analysis they require, their application gives rise to significant controversy. Yet nothing in the NSPS disclosure itself acknowledges the uncertainties inherent in the concept of "modification." To see what a disclosure obligation that takes ambiguity into account looks like, we turn to the tax code.

2. Fuzzy Disclosure Under the Internal Revenue Code

On the other side of the RBS Industries plant, tax attorney Bill Moogan is faced with a disclosure question under the Internal Revenue Code regarding the appropriate tax treatment of clean-up expenditures. When RBS Industries bought the plant some twenty-seven years ago, it, like many businesses at the time, did not even consider the possibility of subsurface contamination. Indeed, it was only when RBS began a plant expansion, including construction of a warehouse facility, that it discovered four large, underground storage tanks. Many of the tanks were corroded and their contents—various types of petroleum products and wastes—had long since seeped into the soil and groundwater. Work on the plant expansion halted as RBS engaged in an expedited and expensive environmental investigation. The investigation culminated in the swift initiation of a cleanup, including tank and soil removal, installation of a soil vapor extraction system, and construction of a network of groundwater wells and associated groundwater treatment systems. With the cost of delaying the plant expansion looming relentlessly in the background, the investigation and cleanup were completed within a single tax year.

After the dust settles, Moogan is left with the dilemma of how to treat the various investigation and clean-up costs for tax purposes. In most circumstances, taxpayers would prefer to treat expenses as deductible from gross income, as this would reduce the tax due for the current year. To achieve this result, the taxpayer must characterize the expenditure as "ordinary and necessary" business expenses under section 162 of the Internal Revenue Code.[81] Ordinary and necessary business expenses include such things as "incidental repairs which neither materially add to the value of the property nor appreciably prolong its life."[82] To the dismay of many taxpayers, section 263 prohibits a current deduction for capital expenditures, which in-

81. I.R.C. § 162(a) (2000).
82. Treas. Reg. § 1.162-4 (1960).

clude amounts paid for "new buildings or for permanent improvements or betterments made to increase the value of any property."[83] Capitalized expenses do not reduce gross income in the current year, and therefore may be far less valuable to the taxpayer. As with many taxation issues, the real world stakes here can be quite high. For example, in the RBS Industries scenario, assuming total costs of investigation and cleanup are $700,000, a current deduction against ordinary income yields a tax benefit as high as $245,000.[84] If, instead, the costs are added to the basis of the land (which is sold in twenty-five years), the tax benefit could be $92,000 or even lower, depending upon your assumptions.[85]

In dealing with the characterization of expenses, the IRS faces the same problem that EPA confronts under the Clean Air Act: the critical information regarding compliance rests primarily with the regulated entity. It is neither practical nor wise for the IRS to descend upon each taxpayer and examine all or even some of their transactions each year. Instead, more so than EPA and many other regulators, the IRS depends heavily on mandatory disclosure for enforcement. And so, much to our collective annual regret, most of us comply with the reporting obligation set out in IRC section 6012(a)(1) and file our tax returns on April 15. Although the tax forms are complicated and in some cases seek significant supporting documentation, they essentially call for only binary disclosure.

Yet in cases where noncompliance reduces tax liability substantially, the IRC adopts a fuzzy disclosure approach. IRC section 6662(d) establishes the substantial underpayment penalty: taxpayers who take an aggressive position on a taxable item and ultimately lose are subject to a penalty equal to twenty percent of the understatement attributable to the position taken.[86] Thus, if RBS Industries reduced its tax liability by $245,000 by improperly characterizing all clean-up costs as deductible items, it would be subject to a $49,000 substantial understatement penalty if discovered. Two escape hatches built into section 6662(d) reflect Congress's recognition of the fact that tax regulations are susceptible to a range of interpretations of varying persuasive force. First, if the taxpayer's ultimately losing position is nonetheless based on "substantial authority," the substantial understatement penalty would not apply.[87] Substantial

83. I.R.C. § 263(a)(1).

84. Based on a marginal tax rate of thirty-five percent.

85. Based on a sale in twenty-five years, with a discount rate of four percent and assuming a marginal tax rate of thirty-five percent. The value could be even less if capital gains are taxed at a lower rate in year twenty-five.

86. I.R.C. § 6662(d).

87. I.R.C. § 6662(d)(2)(B)(i).

authority is typically considered as roughly equivalent to a forty percent likelihood of success if challenged in court.[88] Second, taxpayers lacking substantial authority for a position can still avoid the penalty by disclosing the relevant facts affecting the item's tax treatment in the return or in a statement attached to the return.[89] However, disclosure only saves the taxpayer from the penalty if there is at least a reasonable basis for the position.[90] ("Reasonable basis" is generally described as being roughly equivalent to a twenty percent likelihood of success if challenged in court.[91])

In practice, tax professionals tend to view the substantial understatement provision as raising primarily an issue of disclosure. For example, in the case of RBS, Bill Moogan is likely to explain the provision to firm managers as follows: "Unless we can establish substantial authority for this position, we will have to disclose or else face a significant penalty." This "disclosure-oriented" view is consistent with the Joint Committee's explanation of the operation of the original version of IRC Section 6662(d):

> Congress did not adopt an absolute standard that a taxpayer may take a position on a return only if, in fact, the position reflects the correct treatment of the item because, in some circumstances, tax advisors may be unable to reach so definitive a conclusion. Rather, Congress adopted a more flexible standard under which the courts may assure that taxpayers who take *non-disclosed* highly aggressive filing positions are subject to the penalty while those who endeavor in good faith to fairly self-assess are not penalized.
>
> . . . .
>
> . . . [D]isclosure relief permits taxpayers to avoid the penalty when there is uncertainty as to whether there is substantial authority for the treatment of the item.[92]

Thus, the substantial understatement penalty provision does not "require" disclosure; it merely rewards it by reducing the penalty in the event of an audit. A good-faith actor could choose to ignore the opportunity for disclosure without transgressing the compliance norm. Nonetheless, for purposes of evaluating the relative value of fuzzy disclosure, I will treat the substantial understate-

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88. PENALTY PROVISIONS, *supra* note 63, at 155 tbl.7. The numerical value represents a "general consensus of scholars and practitioners based on a survey of the literature" performed by the Joint Committee staff. *Id.*

89. I.R.C. § 6662(d)(2)(B)(ii).

90. *Id.*

91. PENALTY PROVISIONS, *supra* note 63, at 155 tbl.7.

92. STAFF OF JOINT COMM. ON TAXATION, 97TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, at 217-18 (Comm. Print 1982) [hereinafter REVENUE PROVISIONS] (emphasis added).

ment disclosure provision as a legal requirement so as to demonstrate the potential relationship between the compliance norm and fuzzy disclosure.

IV. BINARY DISCLOSURE AND STRATEGIC NONCOMPLIANCE

What happens when law-abiding, good-faith actors like Kay Burde and Bill Moogan are faced with disclosure issues regarding RBS Industries' compliance? The simple answer is that they will compare the state of affairs at the facility with the required state of affairs laid out in the regulation. If the facility status does not meet or exceed the requirements of the regulation, they will report the deviation. Inject a bit of ambiguity into the regulation, and the story becomes much more complicated, as they now have the opportunity to shape the meaning of the substantive regulation and the basic concept of noncompliance. Part IV.A explores that question with an eye toward understanding how the form of the disclosure obligation might affect the outcome.

A. Ambiguity and the Compliance Decision

Kay Burde's story picks up just as she notifies the plant's operations manager of the potential applicability of the NSPS requirements and the associated disclosure obligation. The operations manager is responsible for making the decision whether to implement the NSPS requirements and whether to notify the EPA of the equipment changes. For purposes of this story, we assume that the operations manager is personally committed to complying with the law and finds institutional support for that stance in the firm's ethics policy. Following that stance in this situation is complicated by the fact that the replacement project has already been approved, the equipment ordered, and the plant production schedules revised to accommodate the replacement work.

In this particular case, complying with the NSPS requirements would be both disruptive and costly for the company. Complying would be disruptive because of the delay involved in designing and installing pollution control equipment and the need to rework production, maintenance, and engineering schedules. Complying would be costly because of the expenses incurred in installing and operating the control technology and the financial losses caused by the delay. The compliance decision will have consequences for the operations manager as well. The financial losses and production delays will negatively impair his ability to meet quarterly and perhaps even annual performance goals set by corporate managers

for the plant and, consequently, for him.[93] Moreover, installing the NSPS pollution controls would require the allocation of capital funds, a prospect that carries additional costs for him. First, in shepherding the capital request through the resource allocation process, he will expend limited personal resources and experience stress and inconvenience.[94] Second, and perhaps more importantly, he faces potential opportunity costs because allocating funds to the pollution control project may restrict his ability to obtain capital funding for other desired projects.[95]

In addition to these financial and organizational costs, the operations manager may also have to deal with "other firm norms and goals that conflict with the compliance norm."[96] One often encounters situations in everyday life in which seemingly inconsistent social norms are triggered.[97] For the firm manager, generally held social norms such as the compliance norm may come into conflict with powerful norms generated within the firm. Common firm norms include the duty to minimize costs or increase revenue and being a "team player."[98] In the RBS Industries example, disrupting the "team's" project and increasing firm costs by insisting on compliance with the NSPS standards could subject the operations manager to the social and psychological sanctions associated with transgressing firm norms.

Consequently, the operations manager will be making the compliance decision under a significant amount of pressure, facing two sets of competing norms and their associated costs. Law and norms scholars would tell us that he will violate the NSPS standards if the material, social, and psychological costs to him for following the compliance norm exceed the costs to him for violating that norm.[99] That may well be the case where the mandates of the respective norms are clear and the manager's alternatives are limited to choosing between those two courses of action. However, this

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93. *See, e.g.*, AYRES & BRAITHWAITE, *supra* note 20; Charles W.L. Hill et al., *An Empirical Examination of the Causes of Corporate Wrongdoing in the United States*, 45 HUM. REL. 1055 (1992); Michael P. Vandenbergh, *Beyond Elegance: A Testable Typology of Social Norms in Corporate Environmental Compliance,* 22 STAN. ENVTL. L.J. 55 (2003).

94. *See e.g.*, Malloy, *supra* note 17, at 471.

95. *See id.*

96. *Id.* at 507; *see, e.g.,* Erik Jansen & Mary Ann Von Glinow, *Ethical Ambivalence and Organizational Reward Systems*, 10 ACAD. MGMT. REV. 814, 815 (1985) (describing the operation of "counternorms" within organizations).

97. ELSTER, *supra* note 21, at 104 ("At any given time we believe in many different norms, which may have contradictory implications for the situation at hand."); Malloy, *supra* note 17, at 507.

98. *See* DEVIANCE IN THE WORKPLACE, *supra* note 32, at 39, 41-47 (Ida Harper Simpson & Richard L. Simpson eds., 1999) (discussing the norm of being a "team player"); Malloy, *supra* note 17, at 507.

99. *See supra* text accompanying notes 93-98.

view fails to consider the possibility that the manager will seek to reconcile the competing norms, rather than choose one over the other. In such cases, the ambiguous nature of the NSPS regulations provides the manager with a bridge between the ostensibly contradictory norms, making the choice between the two unnecessary. In making his decision under such conditions, the manager will likely focus intensely on articulating exactly what "the law" is.[100] If he can define the legal requirement so as to avoid its application to the pump changeout, he will elude both the NSPS requirements and the social and psychological impacts of violating the compliance norm.[101]

Part III observed that in many cases the open texture or ambiguity of regulation results in a range of possible interpretations, ranging from the frivolous to the well-supported.[102] For example, in defining the applicable legal standard, the operations manager would likely focus on characterizing the pump changeout as "routine maintenance, repair, [or] replacement" rather than a modification.[103] EPA applies the term "routine" on a case-by-case basis, looking at four factors in light of business practices in the relevant industry sector: the purpose of the physical change, its nature and extent, its cost, and the frequency of prior similar

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100. In order to simplify the analysis, the scenario assumes that the operations manager is the single individual making both the legal decision of whether the regulations apply and the "business" decision of whether to comply. In a more realistic scenario, the environmental manager would likely make an initial judgment about the applicability of the rule (perhaps in consultation with legal counsel) and advise the operations manager of potential regulatory impacts. The operations manager might then make the final decision of how to proceed, perhaps after more interaction with the environmental manager, legal counsel, and the plant manager. The behavior of each participant in the process would be affected by that participant's level of commitment to the compliance norm and the costs the participant would individually incur by acting in accordance with that norm.

101. One may ask why the manager would choose to interpret the regulation to accommodate a firm norm such as cost reduction rather than redefining the firm norm so as to fit the regulation. One possible answer has to do with the social context in which the decision is being made. While the manager is likely to face some (and perhaps much) resistance from his peers within the firm to altering the shared definition of the firm norm, he is less likely to encounter resistance to redefining the legal requirement. Moreover, the potential costs to him of violating firm norms (which could include significant material and social consequences) may be more tangible than the costs of violating the compliance norm (which may be limited for the foreseeable future to a feeling of guilt and other internal psychological impacts).

102. While different people will judge the strength of a position in different ways, two common metrics are likely: (1) the probability that a court would uphold the position or (2) the level of support found for the position in the relevant controlling authority.

103. Requirements for Preparation, Adoption, and Submittal of Implementation Plans; Approval and Promulgation of Implementation Plans; and Standards for Performance for New Stationary Sources, 57 Fed. Reg. 32,313, 32,316 (July 21, 1992) (to be codified at 40 C.F.R. pts. 51, 52, and 60).

changes.[104] Under a conservative reading of this "four-factor" test, the EPA would likely argue that the RBS Industries replacement project is not routine. The changeout increased the capacity of the production process rather than restoring it to its original design capacity, required a longer shutdown of the facility than other maintenance normally calls for, and was the first such replacement performed at the plant.[105]

In seeking to avoid application of the NSPS, RBS Industries' manager can select from at least three other interpretations of the NSPS and its routine maintenance exception. First, he can argue that the Clean Air Act is unconstitutional, a position generally viewed as bold but frivolous. Second, he can apply EPA's four-factor test differently. For example, he may conclude that although the effect of the replacement may be an increase in capacity, the primary purpose was to reduce the number of production process outages caused by failures of the existing pumps. Rather than engage in repeated repairs, the engineers decided to replace the motors. He may also determine that although RBS Industries has never performed a similar replacement in the last thirty years, other similar plants have, making this type of replacement frequent in the industry although not in this particular company. Third, he may simply reject EPA's four-factor test in its entirety, concluding that evaluations of whether a replacement is routine should be based *only* on whether the activity is common within the industry sector.[106]

Suppose that in this case, Burde evaluated the various interpretations as shown below in Figure 2, in order of ascending level of legal support:

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104. *See In re* Tenn. Valley Auth., 9 E.A.D. 357, 359 (E.A.B. 2000); Letter from Francis X. Lyons, Region 5 Administrator, Environmental Protection Agency, to Henry Nickel, Counsel for the Detroit Edison Company, Hunton & Williams LLP 2 (May 23, 2000) (on file with author) [hereinafter Nickel Letter].

105. The EPA typically takes the position that physical changes having the purpose and effect of increasing operating capacity or efficiency are generally not routine. Nickel Letter, *supra* note 104, at 1; Letter from Donald C. Toensing, Chief, Air Permitting & Compliance Branch, to Wayne E. Penrod, Senior Manager, Environment, Sunflower Electric Power Corporation (August 28, 1998) (on file with author) (concluding that changes resulting in greater operating capacity are not routine). Also, in analyzing the nature of a change, the EPA considers extended shutdowns to typically be associated with nonroutine changes. *Tenn. Valley Auth.*, 9 E.A.D. at 406.

106. *See Tenn. Valley Auth.*, 9 E.A.D. at 393-96 (describing and rejecting that argument by TVA); CLEAN AIR ACT INFO. NETWORK, EPA'S RECENT NSR INTERPRETATIONS CONFLICT WITH FEDERAL AND STATE LAW, 4-5 (March 2000), *available at* http://envinfo.com /caain/may2000/nsr.pdf.

FIGURE 2

INTERPRETATION	LEVEL OF LEGAL SUPPORT
Interpretation *A* (Clean Air Act and NSPS provisions are unconstitutional)	Frivolous
Interpretation *B* (Rejection of four-factor test)	Reasonable Basis
Interpretation *C* (Reading of four-factor test so as to favor RBS)	Reasonable Basis
Interpretation *D* (EPA's strict application of the four-factor test)	Substantial Authority

For most good-faith actors, an obviously frivolous position such as Interpretation *A* would create a direct conflict with the compliance norm and thus be rejected. Interpretations *B* and *C* are more defensible from a normative standpoint, with each being at least a reasonable reading of the provision. Thus, the operations manager can rely on either to concur on the completion of the project absent pollution controls, without feeling that he has violated the compliance norm.[107] Ambiguity in the law therefore offers the good-faith actor the opportunity to have his normative cake and eat it too. However, from the perspective of the regulatory agency, the firm would be in violation of the NSPS and, if detected, would likely be subject to enforcement action.

I want to take a moment to consider the role of economic rationality under these circumstances. I do not mean to suggest that the ra-

107. How, then, would the good-faith strategic actor choose between these two interpretations? Putting aside the role of cognitive biases until later in the Article, there is very little empirical information available on the decision processes used by managers, lawyers, and other compliance professionals to make legal judgments. *See* Marjorie Anne McDiarmid, *Lawyer Decision Making: The Problem of Prediction*, 1992 WIS. L. REV. 1847, 1848-49 (commenting on the lack of empirical information regarding how lawyers make decisions, particularly in discharging the counseling function). *But see* Keith J. Holyoak & Dan Simon, *Bidirectional Reasoning in Decision Making by Constraint Satisfaction*, 128 J. EXPERIMENTAL PSYCHOL.: GEN. 3 (1999); Dan Simon et al., *The Emergence of Coherence over the Course of Decision Making*, 27 J. EXPERIMENTAL PSYCHOL.: LEARNING, MEMORY & COGNITION 1250 (2001) (studying legal decisionmaking in experimental settings and focusing primarily on the processes involved in rendering a verdict or acting as a judge). The decision theory literature discusses a number of strategies used by individuals for making decisions, including the weighted additive rule, the equal weight heuristic, the satisficing heuristic, the lexicographic heuristic, the elimination-by-aspects heuristic, and the majority of confirming dimensions heuristic. *See* JOHN W. PAYNE ET AL., THE ADAPTIVE DECISION MAKER 22-29 (1993) (providing an overview of decision strategies).

tional calculus is irrelevant to Kay Burde and the operations manager in the context of strategic noncompliance. No one has quite figured out how the two interact, but my sense is that economic rationality and normative concerns will act as constraints on one another in compliance decisions. For example, we often see compliance with a clear legal obligation even where both the chances of detection of a violation and the size of the penalty are low. It is likely that in such cases the compliance norm is moderating the effect of economic rationality. Conversely, even where the compliance norm may be satisfied with a doubtful but reasonable position, economic rationality may cause the firm to comply, for example, where the firm's actions are very visible and the penalties for violation are quite high.

B. Social Influences on Strategic Noncompliance

In making the choice between the agency interpretation and his more favorable readings, the manager is likely to be strongly influenced by his immediate social environment.[108] In particular, beyond the firm norms discussed previously, social networks within the firm and external to the firm are also potential sources of encouragement for strategic behavior.

First, the manager may receive support for strategic noncompliance from peers within the firm to the extent that the manager engages others in the decisionmaking process. For example, a manager faced with a compliance decision may discuss the situation with others, including subordinates and peers at the plant, as well as other managers at the corporate office.[109] Psychologists and other social scientists have identified numerous mechanisms by which the behavior of an individual is influenced by the group. In some circumstances, the quality of the decisionmaking outcome may be improved by a group approach, particularly by allowing the pooling of information and skills and the correction of individual biases.[110] However, group discussion can also enhance individual decisionmaking biases and intensify the power of shared firm norms. For example, consider the potential impact of group polarization, a process by which discussion within a group tends to intensify opinion such that the group produces more extreme judgments than existed prior to the group dis-

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108. *See* PAYNE, *supra* note 107, at 254 (noting that decision strategy selection may be influenced by social factors); SCOTT, *supra* note 21; ELSTER, *supra* note 21.

109. Such consultations and discussions could take on attributes of group decisionmaking, although the ultimate decision may rest with one manager.

110. *See* Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 12-27 (2002) (surveying experimental studies comparing individual and group decisionmaking); Mark Seidenfeld, *Cognitive Loafing, Social Conformity, and Judicial Review of Agency Rulemaking*, 87 CORNELL L. REV. 486, 530-35 (2002) (acknowledging that research indicates that group decisionmaking may be superior for problem solving involving analysis and evaluation).

cussion. In groups that share a norm, polarization appears to be caused by the tendency of group members to engage in "social comparison," in which they attempt to signal the strength of their commitment to the norm.[111] Where the group norm is running a lean operation (that is, keeping costs down), polarization can drive individuals within the group to adopt a more aggressive interpretation of a regulation than any single group member might have adopted.[112]

Second, the manager's decision may also be influenced by peers outside the company or by professional advisors who provide both technical support and encouragement of strategic noncompliance. For example, both the environmental manager and the operations manager are likely to be members of trade associations and professional organizations that provide their members with information concerning the industry position on various regulatory issues of importance. This information can often include analysis of agency interpretation of regulations and dissemination of alternative interpretations.[113] The

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111. Seidenfeld, *supra* note 110, at 535-36; *see also* Robert Steven Baron & Gard Roper, *Reaffirmation of Social Comparison Views of Choice Shifts: Averaging and Extremity Effects in an Autokinetic Situation*, 33 J. PERSONALITY & SOC. PSYCHOL. 521, 528-30 (1976). Polarization also appears to be caused by the aggregate effect of the quantity and quality of the information and arguments that the individual may hear in the course of group discussions.

112. *See* Seidenfeld, *supra* note 110, at 536-37 (illustrating how polarization could lead EPA engineers developing a regulation to adopt a more stringent standard than others outside the group would have). Of course, as observed *supra* note 101, polarization can affect many types of attitudes. Why then would not the compliance norm, rather than the cost minimization norm, be enhanced in the group setting? Indeed, in some cases in which the firm has a strong commitment to compliance, polarization might very well lead the firm to "overcomply." In others, however, its impact may well depend on which of several competing norms is most salient at the time the decision is being made. Robert B. Cialdini et al., *A Focus Theory of Normative Conduct: A Theoretical Refinement and Reevaluation of the Role of Norms in Human Behavior*, *in* 24 ADVANCES IN EXPERIMENTAL SOCIAL PSYCHOLOGY 201, 204 (Mark P. Zanna ed., 1991) ("[N]orms motivate and direct action primarily when they are activated (i.e., made salient or otherwise focused upon.")).

113. The EPA's enforcement case against the Tennessee Valley Authority is a useful example. *See In re* Tenn. Valley Auth., 9 E.A.D. 357 (E.A.B. 2000). That case involved fourteen "life extension projects" performed by the Tennessee Valley Authority at nine power plants between 1982 and 1996 in three states, in which TVA replaced or upgraded substantial components of its boilers and replaced thousands of feet of pipe. *Id.* at 365-67. TVA characterized the projects as routine maintenance rather than modifications. TVA argued that a physical change is routine if the activity is common within the relevant industry sector. *Id.* at 393-94. EPA's Environmental Appeals Board rejected the argument and described how trade organization meetings serve as forums for distribution of "how-to" directions for strategic noncompliance:

> Given the extent of rehabilitation efforts . . . , TVA's construction of the exception would, carried to its logical conclusion, allow TVA to rebuild an entire facility without triggering new source review so long as it did so in increments that can be identified elsewhere in the industry. Indeed there is evidence that this was an important part of TVA's design. For example, in 1984, a TVA official made the following statement in notes which he typed and submitted to his supervisor after attending an industry life-extension conference[:]
>
> One statement concerning environmental regulations will need to be kept in

distribution of this type of information by such organizations not only provides managers with the technical and legal positions to support strategic noncompliance but also may enhance the individual manager's perception that the positions are commonly used, defensible readings of the regulation.[114]

Likewise, legal and technical consultants can often provide firms the expertise needed to develop and implement aggressive interpretations of law.[115] For instance, several studies in the area of taxation conclude that the involvement of tax practitioners results in greater noncompliance with respect to ambiguous items and higher levels of compliance for more straightforward items.[116] The legal profession in particular appears to embrace strategic noncompliance as a valuable part of the service it provides to clients.[117] Many lawyers interpret the professional norms that govern their behavior to require that attorneys assist clients in identifying and exploiting ambiguities, gaps,

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> mind if massive unit rehab projects are undertaken. If modifications proposed are extensive enough to be considered reconstruction, EPA might try to apply the new source performance standards. *This could erase one major advantage of life extension over new plant construction*.

Id. at 394-95 (citations omitted).

114. In such circumstances, managers may rely upon the positions disseminated by their respective trade or professional association with less forethought than they would otherwise use. Examples of this type of "herd behavior" in the business community have been discussed by a number of economists and legal scholars. *See, e.g.*, Bainbridge, *supra* note 1, at 1037-40; Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347, 355-56 (1996); David S. Scharfstein & Jeremy C. Stein, *Herd Behavior and Investment*, 80 AM. ECON. REV. 465, 477-78 (1990).

115. *See* Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, *in* 2 TAXPAYER COMPLIANCE 47, 62 (Jeffrey A. Roth & John T. Scholz eds., 1989) (discussing the role of "compliance brokers" in facilitating noncompliance); McBarnet, *supra* note 23, at 339-40 (describing techniques used by accountants to "redescribe" operations in more innocuous terms).

116. *See, e.g.*, James Andreoni et al., *Tax Compliance*, 36 J. ECON. LITERATURE 818, 846-47 (1998); Brian Erard, *Taxation with Representation: An Analysis of the Role of Tax Practitioners in Tax Compliance*, 52 J. PUB. ECON. 163, 165-67 (1993); Steven Klepper et al. *Expert Intermediaries and Legal Compliance: The Case of Tax Preparers*, 34 J.L. & ECON. 205, 228 (1991). *But see* Eric M. Rice, *The Corporate Tax Gap: Evidence on Tax Compliance by Small Corporations*, *in* WHY PEOPLE PAY TAXES 125, 127 (Joel Slemrod ed., 1992) (finding "no clear association of compliance . . . or the use of an outside CPA for tax preparation").

117. For example, section 2.01(b)(1) of the American Law Institute's Principles of Corporate Governance recommends that corporations be obliged to act within the boundaries set by law, a recommendation that is grounded in the "norm of obedience." PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS § 2.01(b)(1) & cmt. g at 60 (1994). The comments to that section go on to note that "[i]n determining these boundaries the corporation should not rest simply on past precedents or an unduly literal reading of statutes and regulations, but should give weight to all the considerations that the courts would deem proper to take into account in their determinations, including relevant principles, policies, and legislative purposes." *Id.* § 2.01 cmt. g at 60.

and loopholes in the law. This perspective is sometimes called the client service model of lawyering.[118]

Several commentators have observed that compliance professionals and lawyers tend to overstate legal risks and obligations, raising the specter of government intrusion and enforcement where there is little likelihood of either.[119] They argue that excessive conservatism in dispensing advice flows in part from self-interested motives, such as increasing fees, establishing power, or minimizing downside risks (in terms of reputational harm and financial liability) associated with being wrong. In addition, the "overstatement" effect, if in fact there is one, is said to result from professional norms of caution.[120] Yet the notion that lawyers and other consultants may overstate legal risk is not fundamentally inconsistent with the idea that those same parties encourage or assist in strategic noncompliance. Take the case of the environmental manager who purposely exaggerates legal risk in order to bolster her importance and influence within the firm. Her reputation as a smart, "can-do" manager is furthered if, in addition to uncovering a significant legal risk, she is able to identify and implement an aggressive interpretation of the law that ultimately avoids that risk.

C. Strategic Noncompliance and Biased Predecision Processing

Thus far, I have discussed factors that the manager consciously takes into account when engaging in strategic noncompliance. Some mention should also be made of "preconscious" influences on the compliance decision; that is, mental processes such as cognitive biases of which the decisionmaker is unaware.[121] In particular, I focus on the phenomenon of biased predecision processing, which occurs when individuals alter their view of the decision environment so as to favor one alternative over another.[122] But first, I will address the "self-serving bias."

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118. For an overview of the debate surrounding the client service model and the competing "public service" model, see David Dana, *Environmental Lawyers and the Public Service Model of Lawyering*, 74 OR. L. REV. 57 (1995); and Ted Schneyer, *Fuzzy Models of the Corporate Lawyer as Environmental Compliance Counselor* 74 OR. L. REV. 99 (1995).

119. Lauren B. Edelman et al., *Professional Construction of Law: The Inflated Threat of Wrongful Discharge*, 26 LAW & SOC'Y REV. 47 (1992); Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L.J. 375 (1997).

120. Langevoort & Rasmussen, *supra* note 119, at 389-99.

121. *See* Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry into Lawyers' Responsibility for Clients' Fraud*, 46 VAND. L. REV. 75, 97 (1993) (defining the concept of preconscious mental processes).

122. Aaron L. Brownstein, *Biased Predecision Processing*, 129 PSYCHOL. BULL. 545, 545 (2003).

Recently, many commentators have used the self-serving bias to explain, among other things, why various forms of self-disclosure and third-party disclosure such as independent auditing are substantially flawed.[123] Reliance on self-serving bias can be problematic when it is invoked without defining the specific bias involved or the particular type of choice or judgment being affected.[124] There is no single definition of the "self-serving bias"; rather, it is an umbrella term for various cognitive biases, each having an egocentric element of some sort.[125] For example, it can refer to skewing judgments of fairness in one's own favor,[126] disregarding newly acquired information that contradicts a position already taken,[127] or attributing more skill, knowledge, or other qualities to oneself than is objectively justified.[128] These biases are driven by different mechanisms and likely exhibit diverse boundary conditions.[129] Accordingly, cautious analysis of the role of a self-serving bias in any given context requires a matching of the type of decision involved with the relevant strand of self-serving bias literature.[130] With that admonition in mind, I selected the strand regarding biased predecision processing, and particularly research on motivated reasoning.

Biased predecision processing can occur in situations in which an individual must choose between two or more alternatives, particularly under conditions of ambiguity.[131] Research in a variety of set-

123. *See, e.g.*, Max H. Bazerman et al., *The Impossibility of Auditor Independence*, SLOAN MGMT. REV., Summer 1997, at 89, 91 (discussing auditor judgments and concluding that "[w]hen people are called on to make impartial judgments, those judgments are likely to be unconsciously and powerfully biased in a manner that is commensurate with the judge's self-interest"); Erica Beecher-Monas, *Corporate Governance in the Wake of Enron: An Examination of the Audit Committee Solution to Corporate Fraud*, 55 ADMIN. L. REV. 357, 380-81 (2003) (arguing that information is processed so as to result in decisions favorable to the decisionmaker); Langevoort, *supra* note 1, at 144 (describing the notion of "self-serving inference" as a "fundamental construct in social cognition"); Robert A. Prentice, *The SEC and MDP: Implications of the Self-Serving Bias for Independent Auditing*, 61 OHIO ST. L.J. 1597, 1606 (2000) (stating that the pervasive human tendency to act consistent with one's own self-interest is caused by a "deliciously complex blend of cognitive limitations and motivational drives").

124. *See* Beecher-Monas, *supra* note 123, at 380-81 (referencing studies regarding egocentric attribution bias in a discussion of why corporate directors may be predisposed to tolerate "iffy" disclosures); Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 NW. U. L. REV. 133, 168-70 (2000) (relying on studies regarding the effect of self-interest on judgments of fairness to support the notion that auditors will skew judgments regarding the adequacy of financial statements).

125. Ward Farnsworth, *The Legal Regulation of Self-Serving Bias*, 37 U.C. DAVIS L. REV. 567, 568 (2003).

126. Bazerman et al., *supra* note 123, at 90-91; Prentice, *supra* note 123, at 1609.

127. Langevoort, *supra* note 1, at 135-39.

128. *Id.* at 139-41; Farnsworth, *supra* note 125, at 569.

129. Farnsworth, *supra* note 125, at 570.

130. For examples of this type of careful analysis, see *id.* at 569-80; Langevoort, *supra* note 1, at 135-48.

131. *See* J. Edward Russo et al., *Predecisional Distortion of Product Information*, 35 J. MARKETING RES. 438, 448 (1998) (noting that information distortion is most pronounced

tings indicates that as individuals begin to evaluate the alternatives, an early favorite will start to emerge. While still in the predecision stage, many individuals will begin to bolster that favorite alternative by restructuring the decision environment so as to support selection of the alternative.[132] Restructuring includes skewing the information sought as part of the decisionmaking process, slanting evaluation of the collected information,[133] and reassessing the perceived positive and negative attributes of the various alternatives.[134]

Much of the research on biased predecision processing involves experimental settings in which the subjects exhibited no significant preference for any of the alternatives at the start of the experiments.[135] During the course of the experiments, the individual's preference for one alternative grew, fed by various bolstering activities.[136] Kunda and other researchers have examined decisionmaking where the individual has a strong preference in terms of outcome before the decisionmaking process begins, a situation somewhat more akin to what goes on in the firm.[137] Under those circumstances, she concluded that individuals engage in a form of biased predecisional processing called "motivated reasoning," in which individuals seek out information and decisionmaking strategies that support the desired outcome.[138] Motivated reasoning apparently reaches within the firm;

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when equivocal information presented).

132. Brownstein, *supra* note 122, at 558. Not all researchers use the term "biased predecision processing" to describe this phenomenon. In their studies of legal decisionmaking, Simon and his colleagues characterize it as bidirectional processing in which "the evidence influences the conclusions and, at the same time, the emerging conclusion affects the evaluation of the evidence." Dan Simon et al., *The Redux of Cognitive Consistency Theories: Evidence Judgments by Constraint Satisfaction*, 86 J. PERSONALITY & SOC. PSYCHOL. 814, 814 (2004).

133. *See, e.g.*, Jürgen Beckmann & Julius Kuhl, *Altering Information to Gain Action Control: Functional Aspects of Human Information Processing in Decision Making*, 18 J. RES. PERSONALITY 224, 226-27 (1984).

134. *See* Henry Montgomery, *Towards a Perspective Theory of Decision Making and Judgment*, 87 ACTA PSYCHOLOGICA 155, 168-69 (1994) (suggesting that individuals build a "dominance structure" so that the favored alternative appears superior to other alternatives on at least one attribute and at least equal to them on other attributes).

135. For example, one typical experiment presented subjects with photographs and biographical profiles of potential partners in a subsequent space flight exercise. *See* Edgar O'Neal, *Influence of Future Choice Importance and Arousal upon the Halo Effect*, 19 J. PERSONALITY & SOC. PSYCHOL. 334 (1971). In another, subjects were asked to choose between two dry cleaners based on six attributes. *See* J. Edward Russo et al., *Predecisional Distortion of Information by Auditors and Salespersons*, 46 MGMT. SCI. 13 (2000).

136. Russo et al., *supra* note 135, at 13.

137. Ziva Kunda, *The Case for Motivated Reasoning*, 108 PSYCHOL. BULL. 480 (1990).

138. *Id.* at 493. Motivated reasoning has also been called "desirability bias" and "allegiance bias." *See* Keith D. Markman & Edward R. Hirt, *Social Prediction and the "Allegiance Bias,"* 20 SOC. COGNITION 58, 58 (2002) (defining allegiance bias as "the rendering of biased predictions by individuals who are psychologically invested in a desired outcome"); Robert A. Olsen, *Desirability Bias Among Professional Investment Managers: Some Evidence from Experts*, 10 J. BEHAV. DECISION MAKING 65, 65 (1997) (defining desirability bias as "the tendency to overpredict desirable outcomes and underpredict unwanted outcomes").

several experimental studies have demonstrated its application to business professionals (including investment managers, auditors, accountants, and salespersons) making expert judgments such as predicting occurrence of potential events of economic significance,[139] predicting the likelihood that a tax position would be sustained in court,[140] and allocating limited resources as between two audit clients.[141]

The notion that motivated reasoning can undermine the compliance norm finds support in a separate line of research in social psychology relating to how norms are triggered. Social psychologists theorize that norm activation occurs when the individual detects cues in the environment that make the norm relevant.[142] The concept of norm activation has been used in analyzing the operation of a variety of social norms, including norms that encourage recycling, management of hazardous chemicals, and energy conservation.[143] Like other social norms, the compliance norm only becomes salient when the individual becomes aware of situational cues that indicate it is ger-

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Motivating reasoning has been demonstrated in a variety of studies by researchers working in different paradigms, some of which look at how people form and reform attitudes and beliefs as well as how they make decisions. Kunda, *supra* note 137, at 493.

139. Olsen, *supra* note 138, at 70.

140. C. Bryan Cloyd & Brian C. Spilker, *The Influence of Client Preferences on Tax Professionals' Search for Judicial Precedents, Subsequent Judgments and Recommendations*, 74 ACCT. REV. 299 (1999); Andrew D. Cuccia et al., *The Ability of Professional Standards to Mitigate Aggressive Reporting*, 70 ACCT. REV. 227 (1995). The Cuccia study is often cited as evidence of motivated reasoning. *See* Russo et al., *supra* note 135, at 13. However, one must be cautious in drawing too much from the study in terms of motivational or cognitive biases. While that study showed, among other things, that accountants will be more or less aggressive in their reporting positions depending upon their clients taste for risk, it provides no direct support for the notion that the behavior was due to preconscious rather than conscious factors.

141. Russo et al., *supra* note 135, at 21-22.

142. ELIOT R. SMITH & DIANE M. MACKIE, SOCIAL PSYCHOLOGY 377 (2d ed. 2000); Cialdini et al., *supra* note 112, at 204; Shalom H. Schwartz, *Normative Influences on Altruism*, 10 ADVANCES EXPERIMENTAL SOC. PSYCHOL. 221, 227, 241 (1977) [hereinafter Schwartz, *Normative Influences*]; Shalom Schwartz, *The Justice of Need and the Activation of Humanitarian Norms*, 31 J. SOC. ISSUES 111, 114-30 (1975) [hereinafter Schwartz, *Humanitarian Norms*] (using norm activation theory to explain the operation of humanitarian norms, meaning norms that encourage helping behavior or altruism such as aiding individuals in distress). "Norm activation" was first articulated as such by Schwartz in analyzing the relationship between humanitarian norms (such as the norm of helping others in need) and actual behavior. *See* Russell Blamey, *The Activation of Environmental Norms: Extending Schwartz's Model*, 30 ENV'T & BEHAV. 676 (1998) (providing an overview of norm activation).

143. *See* J. Stanley Black et al., *Personal and Contextual Influences on Household Energy Adaptations*, 70 J. APPLIED PSYCHOL. 3, 13-17 (1985) (analyzing how norms affect energy conservation); Blamey, *supra* note 142, at 677 (providing a summary of its application in other areas); Gregory A. Guagnano et al., *Influences on Attitude-Behavior Relationships: A Natural Experiment with Curbside Recycling*, 27 ENV'T & BEHAV. 699, 713-14 (1995) (applying the model to recycling); Paul C. Stern et al., *Support for Environmental Protection: The Role of Moral Norms*, 8 POPULATION & ENV'T 204 (1986) (applying the model to management of hazardous chemicals).

mane.[144] However, this initial assessment of external cues is just one element of a complex process. The activation process also includes evaluation of the likely outcomes of complying with the potentially activated norm and of violating it. This evaluation involves consideration of the social, physical, psychological, and moral costs and benefits of each course of action.[145] As in the RBS Industries example, this evaluation may reveal a serious potential conflict, particularly where the economic, social, and psychological costs of both compliance and noncompliance are high.[146]

The individual can avoid this conflict by redefining the situation to ensure the norm is not activated, a process known as defensive denial.[147] In one form of defensive denial, the individual interprets the environmental cues to avoid triggering the norm.[148] For example, in

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144. Elsewhere I have observed that in the context of the firm, "the compliance norm is activated when the firm manager or employee (1) knows of the legal standard, (2) is aware of business activities that are potentially governed by the standard, and (3) believes that he or she has the authority and/or responsibility within the firm to initiate actions leading to compliance." Malloy, *supra* note 17, at 483. These criteria mirror those used by Schwartz and others in applying the norm activation model to humanitarian norms. Schwartz recognized that the concept of norm activation would be useful in understanding the operation of other norms. He hypothesized that among people holding a humanitarian norm, the norm is initially activated where the individual's threshold assessment of a situation results in (1) awareness that another person or group is in need, (2) awareness that actions could be taken in response to the need, and (3) arousal of a sense of responsibility. Schwartz, *Humanitarian Norms*, *supra* note 142, at 116-20.

145. Blamey, *supra* note 142, at 679; Schwartz, *Humanitarian Norms*, *supra* note 142, at 126-28. Schwartz's social costs include blame, fines, loss of promotions, and prosecution. *Id.* at 127.

146. Schwartz, *Humanitarian Norms*, *supra* note 142, at 128 ("Compliance with activated personal norms will satisfy one's sense of moral obligation only at the expense of incurring substantial social, physical, and/or psychological costs.").

147. Schwartz, *Normative Influences*, *supra* note 142, at 255-62; Tom R. Tyler et al., *Defensive Denial and High Cost Prosocial Behavior*, 3 BASIC & APPLIED SOC. PSYCHOL. 267, 267-68 (1982). For purposes of analysis, norm activation and defensive denial are typically described as a sequential process, much as decisionmaking and problem-solving processes are described in other literature. In practice, however, norm activation and defensive denial are unlikely to flow in such a simplified, linear fashion. Rather, the sequence of steps may vary with the particular situation. For example, in some circumstances, defensive denial may occur as part of the threshold assessment rather than as a separate step. Schwartz, *Humanitarian Norms*, *supra* note 142, at 115 ("The way in which the sequence develops in each particular instance is influenced both by situational and intraindividual variables."). Moreover, although the assessments and evaluations are described as if they occur as part of conscious decisionmaking, it is more likely that they are, at least in part, the products of subconscious perceptions, cognitive heuristics and biases, and eventually even habit. *Id.*

148. Schwartz, *Humanitarian Norms*, *supra* note 142, at 128-29. There are two other forms, or "modes," of denial. In the second form of defensive denial, the individual may reassess the situation to reduce any sense of responsibility to act, for example, by concluding that other individuals are better able or more qualified to respond. *Id.* at 128-29. In the third "mode" of denial, the individual may identify conflicting norms that mediate against compliance with the initially activated norm. *Id.* at 129. Used separately and in concert, these three modes of denial allow the individual to evade application of the norm while avoiding the internal sanctions that would otherwise accompany a norm violation. *Id.* at

the case of humanitarian norms, the individual may characterize the situation to understate the other person's need for assistance or the likely harm that person will experience if no aid is given.[149] Likewise, in the case of norms supporting energy conservation, individuals responded to high personal costs by altering their perceptions concerning the seriousness of energy shortages or the harm caused by maintaining current levels of energy use.[150] Two factors influence the "deniability" of the cues in defensive denial: the relative ambiguity of the cues and the interpretation given them by others.[151] As we saw above, each of these factors is certainly at play in strategic noncompliance. In the context of compliance decisions, regulations—the legal standards that trigger the compliance norm—offer a ready and fertile source of ambiguity. Moreover, interpretations offered by the manager's peers outside and inside the firm, as well as advice from the firm's legal and technical consultants, can often provide strong support for aggressive readings of those regulations.[152]

D. The Dubious Role of Binary Disclosure

With all this in mind, I now consider the likely impact of a binary disclosure provision like the NSPS notification obligation on strategic noncompliance. Recall that disclosure operates through three mechanisms: the reflexive mechanism, the deterrence mechanism, and the enhancement mechanism. This Part argues that the simple view of compliance reflected in most binary disclosure provisions undermines all of these mechanisms. With respect to the reflexive mechanism, binary disclosure fails to challenge the firm to be any more sophisticated or self-reflective in making compliance decisions than the firm would otherwise be. Likewise, with regard to the deterrence and enhancement mechanisms, binary disclosure is unlikely to elicit and disseminate the type of information needed to trigger those mechanisms.

1. Binary Disclosure and the Reflexive Mechanism

The reflexive mechanism aims at improving the firm's compliance routines. In other words, by requiring the firm to systematically con-

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129-30; Tyler et al., *supra* note 147, at 268.

149. Schwartz, *Humanitarian Norms*, *supra* note 142, at 128-30.

150. In an experimental study of the effect of personal costs of energy conservation on the conservation norm, Tyler and his colleagues found that increased costs led to belief redefinition of a type that lessened the subjects' perceived need to engage in conservation; that is, subjects exposed to higher costs came to believe that the energy shortage occurring at the time of the study was not serious or that other citizens would not be harmed by lack of conservation. Tyler et al., *supra* note 147, at 269-73.

151. Schwartz, *Normative Influences*, *supra* note 142, at 256.

152. *See supra* Part IV.B.

sider the legal implications of its activities, the regulator hopes to encourage the development of high-level, self-critical organizational processes for identifying legal obligations and evaluating the firm's responses to those obligations.[153] This mechanism thus draws lessons from general management principles. For example, many firms attempt to improve core planning and operational mechanisms by implementing management systems that coordinate various departments, develop policies and decision tools, and establish operating routines.[154] Where those systems use process to facilitate critical thinking about the firm's performance, they take on a reflexive character. Thus, environmental management systems, which use a "plan-do-check-act" cycle to evaluate compliance failures and respond, are often described as reflexive.[155] As I noted above, a number of disclosure programs further reflexive goals in that they mandate or encourage the development of self-reflective processes.[156]

Disclosure like that required under the NSPS provisions falls short of achieving reflexive goals. As a threshold matter, the NSPS provisions ask for a conclusion about compliance but neither require nor reward the firm's implementation of a system for collecting and processing the information needed to reach that conclusion. Such a system would be particularly useful where the firm's compliance problems are caused by poor communication and coordination between firm departments, managers, and employees, what I call "routine noncompliance."[157] Some forms of binary disclosure do include something akin to a system requirement; for example, under Title V of the Clean Air Act, major facilities are essentially required to perform a "reasonable inquiry" to support annual compliance certifications.[158] Where the system requirement is lacking, as in the NSPS notification and many other binary provisions, it is less probable that the disclosure obligation would consistently have reflexive effects.

More importantly, by ignoring ambiguity, binary disclosure fails to force the good-faith manager to critically assess her substantive position regarding compliance. To understand this point, it helps to remember that the manager typically faces the question "Will the firm

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153. *See* Malloy, *supra* note 17, at 495-96 (discussing the potentially reflexive role of environmental management systems).

154. *See* PETER P. SCHODERBEK ET AL., MANAGEMENT SYSTEMS: CONCEPTUAL CONSIDERATIONS (4th ed. 1980) (describing and evaluating the various forms of management systems); Philippe Lorino, *A Pragmatic Analysis of the Role of Management Systems in Organizational Learning*, *in* KNOWLEDGE MANAGEMENT AND ORGANIZATIONAL COMPETENCE 177 (Ron Sanchez ed., 2001).

155. *See* Orts, *supra* note 45, at 1252-54; J.B. Ruhl & James Salzman, *Mozart and the Red Queen: The Problem of Regulatory Accretion in the Administrative State*, 91 GEO. L.J. 757, 848 (2003).

156. *See supra* text accompanying notes 153-55.

157. *See* Malloy, *supra* note 17, at 475.

158. 40 C.F.R. § 70.5(10)(d) (2004).

be in compliance?" in two contexts. First, the manager will consider the question when analyzing the underlying ambiguous substantive requirement. As Figure 3 illustrates, in that context a skilled practitioner of strategic noncompliance would modify the question to become: "Does the firm have a reasonable basis for its position?"[159] In responding to the modified question, the manager will engage in a sophisticated evaluation of alternative viable legal positions and may ultimately select an aggressive, yet arguably reasonable, position.[160]

Second, in dealing with the issue of disclosure, the manager again confronts the question of whether the firm is in compliance.[161] Now, to affect strategic noncompliance in a reflexive way, the disclosure provision should challenge the manager to critically assess her initial compliance evaluation and selected position. Yet, as shown in Figure 3, without something more in responding to a binary disclosure provision that asks for notification of noncompliance, the strategic manager will once again frame the crucial question as "Does the firm have a reasonable basis for its position?" In other words, binary disclosure provisions simply task the manager with answering the same question all over again. As I explain in Part V.B.1, fuzzy disclosure encourages a more critical reassessment of an aggressive legal position by forcing the strategic, good-faith manager to frame the question differently when making a compliance determination for purposes of disclosure.

FIGURE 3

BINARY DISCLOSURE: THE TWO DECISIONS	
Substantive Decision	Disclosure Decision
Question: Will the firm be in compliance?	Question: Will the firm be in compliance?
Framed As: Does the firm have a reasonable basis for its position?	Framed As: Does the firm have a reasonable basis for its position?

159. Clearly, the manager might also consider a variety of other factors in determining which position of several to adopt beyond the legal sufficiency of the positions. For example, the firm may gain some reputational value from adopting a conservative stance. For purposes of this analysis, I focus on this particular factor.

160. *See supra* text accompanying notes 102-07.

161. I do not mean to suggest that a manager would necessarily deal with the issues of substantive compliance and disclosure sequentially, although I believe that that does occur in many cases. It may be that some or many managers consider both aspects in tandem. Nonetheless this does not undercut my point here, which is that, depending upon its design, the disclosure provision could encourage the manager to be more critical in evaluating potential compliance positions than the manager would be otherwise.

2. Deterrence, Enhancement, and Binary Disclosure

Binary disclosure hobbles the reflexive mechanism by asking nothing more of the manager than the underlying substantive rule does. This feature of binary disclosure also weakens the vitality of the deterrent and enhancement mechanisms. The strength of these mechanisms varies with the capacity of the disclosure provision to deliver information regarding compliance to the recipient regulator or other third party. For deterrence, the knowledge that the regulator will possibly take action in response to strategic noncompliance may cause the manager to shift her interpretation so as to avoid that agency reaction. For enhancement, the regulator actually takes action and forces a change in the firm's behavior. Yet neither can happen if the disclosure provision allows the good-faith manager to rely upon an aggressive reading of the substantive rule in question to likewise avoid disclosure.

Again the RBS Industries case provides a useful example. The NSPS notification provision asks the operations manager whether the project is a modification. In performing their analysis of the underlying substantive requirement, Kay Burde and the operations manager have already considered that question. They have already struggled with the choice among the various potential positions, evaluated the magnitude of legal support for each position, and concluded what magnitude of legal support—be it a reasonable basis or substantial authority or something else—is called for by the compliance norm and other individual and firm norms. Having done all that, they concluded that the NSPS emission control requirements could be ignored without violating the compliance norm.

That said, there is little more to this story. Both the substantive pollution control requirements and the procedural disclosure obligation are triggered by a modification. Absent any reporting position in the disclosure provision itself, requiring a more stringent level of legal support, it is difficult to believe that the firm would interpret "modification" differently in deciding whether disclosure is necessary than it did in determining whether control devices are required.

I say *difficult* to believe rather than *impossible* for good reason. My analysis assumes that the substantive decision and the disclosure decision were made close in time and by the same decisionmakers. If we relax those assumptions, there is a greater likelihood that the two determinations could vary. For example, the NSPS notification must be made shortly before the proposed modification is implemented. Other binary disclosure regimes call for periodic compliance reports, thus creating the possibility that some intervening event could occur between the initial compliance decision and the subsequent reporting decision. That intervening event could involve a shift in the relevant

judicial or administrative legal authorities relied upon by the manager. Alternatively, a different person could become involved in the disclosure decision, bringing with them a different balance of background, goals, and social and normative influences. Suppose that the disclosure decision is made as part of an annual audit performed by a compliance unit within the firm or by a third-party auditor. Their incentive structure and their organizational goals may cause them to implement the compliance norm in a more aggressive manner.

My point here is not that binary disclosure can never support the deterrent or enhancement mechanisms. Rather, only that on balance, there is strong reason to be skeptical of the value of binary disclosure as an enforcement tool, even where we believe that the regulated firms and individuals are law-abiding actors. In the next Part, I examine the case for fuzzy disclosure.

V. STRATEGIC NONCOMPLIANCE AND FUZZY DISCLOSURE

On the other side of the RBS plant, Bill Moogan is still puzzling over how to characterize the costs of the underground storage tank remediation. The firm has significant ordinary income for the tax year and would like to be able to deduct the bulk of the remediation costs immediately.[162] If the expenses were to be capitalized into the cost basis of the land, the firm would capture the tax benefit only upon the sale of the land. Because RBS has no intention of selling in the foreseeable future, this characterization significantly reduces the present value of the deductions. As in the case of binary disclosure, it is helpful to analyze Bill's response to these issues by splitting the substantive decision from the disclosure decision.

A. The Substantive Decision

Drawing the distinction between deductible and capital expenditures is a classic and persistent problem in tax planning, enforcement, and litigation. It has spawned an astonishing amount of statutory and administrative tinkering, judicial tests and policy, and scholarly rumination.[163] While the underlying tax policy for the distinction is relatively straightforward, applying the distinction in a clear and consistent fashion has proven to be quite challenging.[164]

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162. There is little doubt that costs of construction, groundwater extraction, and treatment equipment should be capitalized, as they are associated with the creation of an asset with a useful life longer than one year. Treas. Reg. § 1.263(a)-2(a) (as amended in 1987).

163. *See generally* Byron Pavano, Note, *Life in All Its Fullness: A Discussion of Capitalization v. Deduction*, 39 B.C. L. REV. 253 (1997).

164. Sections 162 and 263 are designed to match income in any given taxable period with the expenses that generated it to reach an accurate calculation of net income for tax purposes. *See, e.g.*, INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 85-86 (1992); Comm'r v. Idaho

This is no less so in the context of remediation expenses. Despite several judicial decisions and a series of Internal Revenue Service revenue rulings and pronouncements, there is still much room for disagreement over how established tests of deductibility and capitalization apply to the wide range of cleanup scenarios.[165]

Generally speaking, under section 263(a)-1 of the Code, business expenses that neither increase the value of property materially nor appreciably prolong its useful life are immediately deductible as ordinary and necessary business expenses.[166] Thus, expenditures that simply maintain real property (such as a building or land) or restore it to its original use could be deducted.[167] In the context of environmental cleanups, the relevant test for determining whether clean-up costs increase the value of property is to compare the status of the land after the cleanup with the status of that land before it was contaminated.[168] If the cleanup simply restores the land to its original condition without putting it to a new use, then the expenditures are deductible, so long as no other provisions of the Internal Revenue Code require different treatment.[169]

So far, so good. But Bill faces two challenges in constructing an argument in favor of deductibility. First, the contamination at the RBS plant appears to have occurred *before* RBS purchased the property. In those circumstances, the IRS contends that the baseline for determining the land's "original condition" is the date of acquisition by the taxpayer.[170] By comparing the original contaminated condition as of the time of acquisition to the condition of the land immediately after cleanup, the agency concludes that the taxpayer has permanently improved the land. Under the treasury regulations defining capital expenses, expenditures that permanently improve an asset must be capitalized.[171] Moreover, two federal courts of appeals have held that remediation expenditures similar to RBS Industries' must be capitalized.[172] Still, the law on the tax treatment of remediation expenditures is far from settled. Bill can rely on general caselaw re-

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Power Co., 418 U.S. 1, 16 (1974).

165. *See* United Dairy Farmers, Inc. v. United States, 267 F.3d 510 (6th Cir. 2001); Dominion Res., Inc. v. Comm'r, 219 F.3d 359 (4th Cir. 2000); Norwest Corp. v. Comm'r, 108 T.C. 265 (1997); Rev. Rul. 04-18, 2004-8 I.R.B. 509; Rev. Rul. 94-38, 1994-1 C.B. 35.

166. Treas. Reg. § 1.263(a)-1(b) (as amended in 1993).

167. One exception to the restoration principle applies if the taxpayer has taken depreciation or depletion allowances with respect to the asset. I.R.C. § 263(a)(2) (2000).

168. *See* Plainfield-Union Water Co. v. Comm'r, 39 T.C. 333, 338 (1962), *nonacq. on other grounds*, 1964-2 C.B. 3.; Rev. Rul. 94-38, 1994-1 C.B. 35.

169. Rev. Rul. 94-38, 1994-1 C.B. 35.

170. *See* Priv. Ltr. Rul. 1999952075 (August 28, 1999).

171. Treas. Reg. § 1.263(a)-1.

172. *See* United Dairy Farmers, Inc. v. United States, 267 F.3d 510 (6th Cir. 2001); Dominion Res., Inc. v. Comm'r, 219 F.3d 359, 359 (4th Cir. 2000).

garding rehabilitation of land to dispute the IRS's position.[173] And at least one of the appellate court decisions could be distinguished on its facts: in that case the taxpayer incurred the clean-up costs for the purpose of preparing a former power plant property for use as an office complex.[174] RBS has no plans to so radically convert the land to a new use.

Second, Bill must also deal with the application of section 263A of the Code, which requires that direct costs and indirect costs properly allocable to the production of inventory be included in inventory costs.[175] Thus, for a manufacturing plant like RBS, generally deductible business expenses (such as labor costs or interest expenses) associated with manufacturing operations must be included in the cost of goods sold rather than deducted immediately. The problem is that the IRS considers remediation expenses at manufacturing facilities to be "incurred by reason of [the taxpayer's] production activities" within the meaning of the section 263A regulations, meaning that those expenses must also be included in inventory costs.[176] Just how bad this is for a taxpayer depends on the method of inventory accounting the firm uses. Because RBS Industries has adopted FIFO (first-in, first-out) inventory accounting and has a fairly large inventory at present, there may be some significant delay before the firm captures the tax benefit of the expenses.[177] The agency's position on inventory costs is weaker than its position on capitalization into the land. The former position is based solely on an informal interpretation of the regulations set out in a private letter ruling without any supporting caselaw,[178] and the critical language—"such property's proper share of those indirect costs (including taxes) part or all of which are allocable to such property"[179]—is quite ambiguous.

In making his decision about the proper tax treatment of the clean-up expenditures, Bill Moogan faces an organizational environment similar to that facing Kay Burde. The normative drive to comply with the law will run up against competing organizational and professional norms that encourage the adoption of aggressive, tax-

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173. *See Plainfield-Union Water*, 39 T.C. at 333.

174. *Dominion Res.*, 219 F.3d at 372. Indeed, the *Dominion* court declined to use the IRS's post-acquisition-condition/post-cleanup-condition test, relying instead on the notion that the taxpayer was able to convert the property to an entirely new use. *Id.*

175. I.R.C. § 263A (2000).

176. Rev. Rul. 04-18, 2004-8 I.R.B. 509.

177. DECHERT LLP, IRS ISSUES TWO REVENUE RULINGS ON ENVIRONMENTAL REMEDIATION (Mar. 2004) (on file with author).

178. *See* Estate of McLendon v. Comm'r, 135 F.3d 1017, 1023-24 (5th Cir. 1998) (stating that revenue rulings are given less deference than agency's formally promulgated regulations).

179. I.R.C. § 263A(a)(2)(B).

reducing positions. Like Kay, Bill will be influenced by his social network and by preconscious motivational and cognitive biases. For purposes of this discussion, I assume that this mix of norms, social influences, and biases leads Bill to conclude that there is a reasonable basis for immediate deduction, an aggressive position that the agency would view as strategic noncompliance. Yet the existence of a reasonable basis allows Bill to take this position without violating the compliance norm.

B. The Disclosure Decision

The tax code establishes at least two disclosure requirements that could affect Bill's ultimate treatment of the costs. The first is the basic obligation to file an income tax return for the firm. In this context, that filing requirement is essentially binary disclosure; the corporate return asks only for conclusions regarding deductibility and does not inquire as to the strength of or legal support for those conclusions. However, the separate substantial understatement penalty provisions also establish a fuzzy disclosure regime by waiving the twenty percent penalty for taxpayers who disclose aggressive positions, that is, positions lacking "substantial authority." As I noted above, for purposes of illustration, I am treating this as an obligation to report positions that lack substantial authority.[180] Substantial authority exists where "the weight of the authorities that support the taxpayer's position [is] substantial when compared with those supporting other positions."[181] Although Bill believes that there is a reasonable basis for deducting the clean-up costs, given the recent cases and revenue rulings, he is not convinced that there is substantial authority for this position. The remainder of this Part considers how the fuzzy disclosure provision could affect Bill's ultimate treatment of the item under these circumstances. As with binary disclosure, I examine the potential roles played by the reflexive, deterrent, and enhancement mechanisms in minimizing the frequency and magnitude of strategic noncompliance.

1. Accountability and the Reflexive Mechanism

Unlike binary disclosure, fuzzy disclosure challenges the individual to think more closely about the position taken than would be the case absent the disclosure obligation. At the conscious level, the explicit statement of a heightened baseline reporting standard—in this context substantial authority—may cause Bill to be more exacting in

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180. *See supra* Part V.A; PENALTY PROVISIONS, *supra* note 63, at 153 (describing accuracy-related substantial understatement penalty waiver provisions as "[s]tandards requiring disclosure of tax return position to IRS").

181. REVENUE PROVISIONS, *supra* note 92, at 217-18.

his evaluation of the legitimacy of the position. Moreover, in addition to the higher level of legal support brought to bear by the disclosure provision, the economic stakes are higher. Failure to disclose can result in a significant penalty. Yet, the preconscious impact of fuzzy disclosure may be equally or even more important than these conscious factors when one considers the potential effect of accountability.

Psychological research regarding the impact of accountability on behavior suggests that fuzzy disclosure could have some meaningful bearing on strategic noncompliance. For these purposes, "accountability" is defined as the expectation that one may be called upon to justify one's beliefs and actions to others.[182] A good-faith actor in Bill's position would very likely experience such an expectation with respect to at least two "audiences." As an initial matter, Bill will proceed under the assumption that if the firm does in fact deduct the costs, it should also explicitly disclose that position to the IRS. While the existence of a "reasonable basis" for deductibility ensures that the compliance norm will be satisfied, it does not satisfy the more stringent substantial authority standard of the disclosure provision.[183] Thus, Bill anticipates that the IRS will be aware of the firm's position and that he may very well be called upon to justify that position before the agency. Second, it may be that other senior tax professionals or upper-level managers within the firm will evaluate Bill's conclusions regarding both deductibility and disclosure. This second audience could have significantly different views than the IRS about deductibility.

While there has been a significant amount of research regarding accountability and decisionmaking,[184] little of it has explored the effects of accountability cross-pressures, that is, the existence of *two*

182. *See* Tetlock, *supra* note 57, at 337. Accountability is a multifaceted concept and can include effects from the mere presence of observers of action, evaluation by others, and the obligation to explain one's self. Jennifer S. Lerner & Philip E. Tetlock, *Accounting for the Effects of Accountability*, 125 PSYCHOL. BULL. 255, 255-56 (1999).

183. Bill's sense that disclosure is necessary could have two grounds. First, from the perspective of economic rationality, Bill may feel that the risks of losing on the question of deductibility and incurring the large substantial understatement penalty (and other penalties and interest) outweigh the value of the deduction. Second, to the extent that Bill views disclosure under the substantial understatement penalty rules as something akin to a legal obligation, the compliance norm would lead him to view disclosure as necessary here, where the position is not supported by substantial authority. I recognize that as actually drafted, the substantial understatement penalty provisions do not require disclosure; they simply reward it in some circumstances. In using fuzzy disclosure in the future, regulators may want to be careful to cast it as an obligation rather than a reward in order to leverage the power of the compliance norm.

184. For helpful and concise summaries of the literature, see Lerner & Tetlock, *supra* note 182; Mark Seidenfeld, *The Psychology of Accountability and Political Review of Agency Rules*, 51 DUKE L.J. 1059 (2001); Tetlock, *supra* note 57.

audiences with known, contradictory views.[185] Based on the limited work on this issue, we know that Bill may respond to accountability cross-pressure by using either of two classes of coping strategies.[186] First, he may engage in decision-avoidance strategies, such as procrastination, passing the buck, or exiting the situation. Those of us who have worked in government bureaucracies, business firms, or other organizations can probably recount numerous stories of decision-avoidance strategies in action. In our case, however, some decision must be made by a certain date about how to treat clean-up expenses. Otherwise, the tax benefit, whatever it may be worth, will be lost.[187] So I assume that Bill will not avoid the decision of how to treat the item for tax purposes.

Second, Bill may engage in "high-cognitive-effort attempts to form integratively complex positions on the issue at hand."[188] In other words, he will devote more cognitive resources to assessing the relative positions of the audiences and will be more critical of each. Moreover, he may attempt to find a compromise position that could satisfy both audiences.[189] In some or perhaps in many cases involving regulatory compliance, the individual may not be able to identify a suitable compromise position. For example, it is difficult to see an appropriate "middle-of-the-road" interpretation of the tax issue facing Bill. Nonetheless, the individual would still potentially engage in

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185. *See* Michael Gibbins & James D. Newton, *An Empirical Exploration of Complex Accountability in Public Accounting*, 32 J. ACCT. RES. 165, 168 (1994) (noting that public accountants are likely to face multiple sources of accountability); Melanie C. Green et al., *Coping with Accountability Cross-Pressures: Low-Effort Evasive Tactics and High-Effort Quests for Complex Compromises*, 26 PERSONALITY & SOC. PSYCHOL. BULL. 1380, 1381 (2000) ("Research has only begun to explore the role of different . . . audiences in determining individuals' responses to accountability pressure."). Existing research also does not address the effects of accountability where the audience and the individual have an adversarial relationship. *See id.* at 1389.

186. In this study, Green, Visser, and Tetlock provided the undergraduate experimental subjects with materials setting out arguments on both sides of the free trade issue. Students in the accountability group were led to believe that they would have to justify their views to an audience: in some cases a pro-free trade audience, in other cases an anti-free trade audience, and in still others a mixed pro- and anti-free trade audience. Green et al., *supra* note 185, at 1382-84. As far as I know, the only other published study of accountability cross-pressures is Gibbins & Newton, *supra* note 185. In that study, the authors surveyed 156 public accountants regarding their perception of the existence and impact of accountability cross-pressures.

187. One can imagine a situation in which a particularly stressful compliance issue could be passed from one individual or department to another until it is lost in the bowels of the firm. For example, assume that the NSPS notification was structured as fuzzy disclosure, and that Kay Burde and others in the firm engaged in decision-avoidance rather than taking a stand about NSPS applicability. The issue may become an orphan, and a decision not to install control equipment could be made by default. This is an interesting situation in which what begins as a potential instance of strategic noncompliance ultimately morphs into an act of routine noncompliance.

188. Green et al., *supra* note 185, at 1387.

189. *Id.* at 1381.

more sophisticated evaluation of the alternative positions than under a binary disclosure scenario, and that is precisely what the reflexive mechanism seeks.

Having said that, I want to raise a couple of cautionary notes here. First, each of the coping strategies discussed above is subject to boundary conditions.[190] For example, in some accountability cross-pressure situations, the integrative complexity that arises may be relatively mindless, in which case the individual tries to find middle ground without first discounting weak or specious arguments raised by the audiences.[191] Second, research on accountability in the complex context of the business firm and regulatory environment is still quite young. Although the phenomenon of accountability has also been observed in field experiments in several industries,[192] we have yet to see much work on accountability cross-pressures in a business environment. Thus, the usual concerns about applying experimental results obtained from a population of undergraduate students too quickly to the cognitively messy world of the business firm certainly apply here.[193] Nonetheless, current and future accountability research does offer a potentially important source of information in evaluating and designing disclosure regimes.

2. The Deterrence Mechanism and Fuzzy Disclosure

As part of the deterrence mechanism of disclosure, the individual anticipates the likely reaction of the information recipient and, where appropriate, alters his or her own behavior so as to obviate disclosure and thus avoid the expected reaction. Use of a fuzzy disclosure structure can assist this process in two ways. On the conscious level, it can increase the likelihood that the good-faith actor believes that disclosure is required. On the preconscious level, it can boost the probability that the individual will change his or her position in light of the recipient's reaction. I start with the impacts on the conscious level. If Bill concludes, as Kay Burde did, that no disclosure of the firm's position is required, the engine of the deterrence mechanism will slowly spin to a stop. No disclosure means no government or third-party reaction. If, instead, Bill determines that the law calls for dis-

190. For example, the individual's personal need for cognition may moderate the use of decision-avoidance strategies. *Id.* at 1382.

191. *Id.* at 1388 (noting that both forms of integrative complexity have been documented "but the boundary conditions for their occurrence have yet to be delineated").

192. *See* David Antonioni, *The Effects of Feedback Accountability on Upward Appraisal Ratings*, 47 PERSONNEL PSYCHOL. 349, 352-55 (1994) (insurance agents); Patricia M. Fandt & Gerald R. Ferris, *The Management of Information and Impressions: When Employees Behave Opportunistically*, 45 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 140, 142-43 (1990) (customer service representatives); Lerner & Tetlock, *supra* note 182, at 257 (surveying the literature).

193. *See* Seidenfeld, *supra* note 110, at 490.

closure, as a good-faith actor he will either disclose or alter his position so as to avoid disclosure. The value of fuzzy disclosure lies primarily in its capacity to force the good-faith actor to conservatively define compliance for purposes of disclosure. In the RBS case, Bill is able to take an aggressive substantive position by defining "compliance" by reference to a fairly liberal standard of legal support, such as "reasonable basis." For purposes of identifying compliance in fuzzy disclosure, the regulator requires Bill to measure his position against a more exacting standard, such as "substantial authority." So a position that constitutes compliance for purposes of the substantive law is characterized as noncompliant with regard to disclosure. The regulator thus takes advantage of the spread between the two standards of legal support, bringing the compliance norm to bear on the disclosure question.

Assuming Bill therefore concludes that disclosure is required, the potential costs flowing from disclosure may lead him to alter his substantive position on the tax treatment of the clean-up costs. At first blush, the downside of disclosure may seem limited, even if it results in the IRS disallowing the claimed deduction. By disclosing, Bill protects himself from substantial understatement penalties,[194] limiting the economic aftermath of the denied deduction to payment of the tax and interest. That all assumes, of course, that the agency actually acts upon the disclosure; if not, then RBS will continue to benefit from the immediate deduction. However, when he considers the indirect impacts of disclosure, Bill may choose to moderate or even abandon the aggressive position. For example, in the event an audit is triggered by the disclosure, it will probably not be limited to just the remediation expenditures, but instead may encompass all items of income and deduction on the return. Beyond the risk of adjustment to other return items, the audit itself will generate transaction costs in terms of resources expended preparing for the audit and fees paid for attorneys or other tax professionals.[195]

Under certain circumstances, accountability pressures at the preconscious level could also cause Bill to reduce the aggressiveness of his tax position. Earlier I assumed that Bill was accountable to an internal audience of firm managers and senior tax professionals, creating accountability cross-pressures. If, instead, we assume that Bill's tax judgments are accorded significant deference within the firm,[196] he faces only one source of accountability: the IRS. Accountability re-

194. If he is right about having a reasonable basis for his position, he should also be safe from negligence penalties.

195. Beck et al., *supra* note 11, at 245.

196. As a tax attorney, Bill has professional expertise which sets him apart from others in the firm and which may engender some level of deference. My tax colleagues on our faculty assure me that this is the case with all tax attorneys!

search suggests that when individuals are accountable to an audience with known views, they exhibit a tendency to conform their own views to those of the audience.[197] This phenomenon may reflect the individual's desire to avoid the cognitive efforts needed to carefully evaluate the audience's view, as well as the individual's psychological drive to seek approval from the audience.[198] I do not mean to suggest that Bill's judgment would be substantially clouded by cognitive laziness or intellectual pandering, but only that he may exhibit the tendency to give the agency's position more deference when disclosure is in the offing.

The effects of accountability are complicated and may be influenced by motivational factors just like other cognitive phenomena. The tendency of individuals to skew their position toward that of a known audience is no exception. The extent to which individuals may conform to the audience's view depends upon the individual's motivational goals.[199] For example, in recent experimental studies, participants who were primed to make accurate, objective judgments displayed significantly less conformity than participants who were motivated to "get along."[200] Assuming the results of these studies transfer to other types of motivational goals, the conformity effect of accountability may be moderated or offset in Bill's case by professional norms of client service, by organizational norms encouraging the reduction of costs, or by any number of other goals that drive Bill's behavior.

A last note about timing is also in order here. The conformity effect discussed above is typically limited to situations of predecisional accountability, meaning cases in which the individual learns of the need to justify her actions before she commits herself to a particular decision. Where the individual becomes aware of accountability pressure during the postdecision period, she is more likely to engage in defensive bolstering in which she focuses her cognitive efforts on rationalizing the decision, rather than critically assessing its merits.[201] As I

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197. Gibbins & Newton, *supra* note 185, at 180; Lerner & Tetlock, *supra* note 182, at 256-57. We should note, of course, that other factors can affect the individual's response to accountability, including the individual's perception of the audience's legitimacy, the individual's taste for cognitive complexity, the importance of the issue, and the extent to which the audience is focused on outcomes versus the procedures used to reach those outcomes. *Id.* at 257-59.

198. Roy F. Baumeister & Mark R. Leary, *The Need to Belong: Desire for Interpersonal Attachments as a Fundamental Human Motivation*, 117 PSYCHOL. BULL. 497, 500 (1995); Lerner & Tetlock, *supra* note 182, at 256-57.

199. Lerner and Tetlock, *supra* note 182, at 257.

200. Serena Chen et al., *Getting at the Truth or Getting Along: Accuracy- Versus Impression-Motivated Heuristic and Systematic Processing*, 71 J. PERSONALITY & SOC. PSYCHOL. 262 (1996); Andrew Quinn & Barry R. Schlenker, *Can Accountability Produce Independence? Goals as Determinants of the Impact of Accountability on Conformity*, 28 PERSONALITY & SOC. PSYCHOL. BULL. 472 (2002).

201. Brownstein, *supra* note 122; Lerner and Tetlock, *supra* note 182, at 257-58.

noted above, we should be careful not to rely too quickly on this research in developing disclosure policy. That said, pre- and postdecisional research does underscore the potential influence of the structure of disclosure provisions on outcomes. For example, if the pre- and postdecision dichotomy turns out to be applicable in the context of compliance disclosures, it may warrant a heavier reliance on contemporaneous disclosure of violations, rather than periodic disclosure (such as annual compliance certifications). By linking the disclosure decision with the compliance assessment temporally, regulators could avoid the defensive bolstering that might result where someone in the firm takes a substantive position one month and that person or another makes the disclosure decision some time much later.

3. Enhancement and Fuzzy Disclosure

This is perhaps the simplest story to tell. I observed above that fuzzy disclosure increases the chances that the good-faith actor will determine that disclosure is required. In that event, Bill will either alter his position so as to avoid the disclosure obligation or will divulge the relevant information. The deterrent mechanism seeks the former, and the enhancement mechanism pursues the latter. When the firm chooses disclosure, the enhancement mechanism is set into motion, and the next move rests with the regulator or other recipient.[202]

VI. THE LIMITS OF FUZZY DISCLOSURE

Although my evaluation of fuzzy disclosure thus far is mixed, it does appear that fuzzy disclosure could be a somewhat effective tool for dealing with strategic noncompliance. Yet strategic noncompliance is a tenacious animal, and it cannot be wrangled so easily. While fuzzy disclosure may have advantages over binary disclosure, regulators must be careful in designing and implementing it. This Part highlights two potential obstacles to the effective use of fuzzy disclosure: the inherent ambiguity of fuzzy disclosure and the risk of norm-based resistance to expanded disclosure.

A. Strategic Noncompliance Squared

The irony is that the very thing that makes fuzzy disclosure work—the conservative reporting standard (such as "substantial authority")—may itself be wildly ambiguous. Commentators and practi-

202. The response of the regulator is beyond the scope of this Article. Nonetheless, it is worth noting that the effectiveness of the disclosure mechanism does depend in some measure on diligent review and action on disclosures. Paredes, *supra* note 35, at 418 ("In short, if the users do not process information effectively, it is not clear what good mandating disclosure does."). If the regulator consistently fails to respond to disclosed violations, the deterrent function of the disclosure regime will be adversely affected.

tioners alike have grumbled about the vague, open-ended nature of standards such as substantial authority or reasonable possibility.[203] That ambiguity suggests that fuzzy disclosure provisions may be just as vulnerable to strategic noncompliance as any other regulation.

There is some empirical evidence of this vulnerability. In two experiments, Cuccia and his colleagues investigated whether tax practitioners use the ambiguity of reporting standards to support aggressive reporting positions. In the first experiment, thirty-four experienced tax managers from Big Six accounting firms were asked to review a hypothetical case file, including a comprehensive synopsis of a tax issue, a client description, copies of relevant court cases, IRC sections and regulations, and a fictitious reporting standard. Two different client descriptions were used. Some participants received an aggressive, risk-taking yet law-abiding client (aggressive disclosure condition), while others received a conservative, risk-neutral, law-abiding client (conservative disclosure condition).[204] Each participant was to recommend either an aggressive position (exclusion from income) or conservative position (inclusion of the item in question in taxable income) to his or her client. The participants in the two distinct groups were faced with the identical factual situation, legal authorities, and reporting standard (in this case "reasonable likelihood"). The study found that only nineteen percent of the participants in the conservative disclosure condition chose the aggressive reporting position, while eighty-eight percent of those in the aggressive disclosure condition adopted the aggressive position.[205] These results were statistically significant.[206]

In the second experiment, the researchers sought to understand the relative importance of the stringency of the reporting standard on the one hand and the strategic drive of the tax professional on the other.[207] A second set of thirty-one tax managers received materials similar to those in the first experiment, with two exceptions. First, all participants were subjected to the aggressive disclosure condition and thus had equal incentive to act strategically in deciding the tax issue. Second, each participant received one of two reporting standards, each being more stringent than the standard used in the first experiment. The results indicated that the participants' reporting decisions were no less aggressive under the more stringent reporting

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203. *See, e.g.*, Ronald A. Davidson, *Practical Difficulties Encountered in Selecting Uncertainty Words: The Example of Accounting Standards*, 40 APPLIED PSYCHOL.: INT'L REV. 353, 354-55 (1991) (discussing the inherent ambiguity in "uncertainty words," that is, words used to articulate levels of frequency and uncertainty); Gwen Thayer Handelman, *Constraining Aggressive Return Advice*, 9 VA. TAX REV. 77, 100-02 (1989).

204. Cuccia et al., *supra* note 140, at 234.

205. *Id.* at 235.

206. *Id.*

207. *Id.* at 238-40.

standards than under the less stringent reasonable-likelihood standard used in the first experiment.[208] The study's authors concluded that the participants were able to maintain their aggressive stance even in the face of more stringent reporting standards by shifting their strategic focus to the analysis of the evidence.[209]

The fact that fuzzy disclosure may be vulnerable to strategic noncompliance does not necessarily rob it of all value. As I discussed at the outset, most ambiguous regulation has a range of potential interpretations, ranging from the frivolous to reasonable and beyond. Even admittedly vague terms can come to have a set of generally accepted meanings within the relevant practice area, which constrain somewhat the interpretations that a good-faith actor will adopt. If that is true, then reporting standards such as substantial authority may still serve a screening mechanism of sorts. The most aggressive good-faith actors will still avoid disclosure by massaging the reporting standard or the facts of their case. Less aggressive good-faith actors will acknowledge the need to disclose and act in accordance with that conclusion. In considering whether the limited net cast by fuzzy disclosure is a failure, one must ask, "As compared to what?" As ambiguous as fuzzy disclosure's reporting standards may be, binary disclosure's lack of any reporting standards is far more troublesome.

B. Legitimacy and Fuzzy Disclosure

This last point brings us full circle in our discussion of the relationship between the compliance norm and disclosure. Recall that one of my governing assumptions is that the behavior of firm actors is strongly influenced by the compliance norm, a social norm that encourages obedience to the law.[210] This Article has largely focused on ways in which regulators can leverage the influence of the compliance norm to boost the power of reflexive, deterrent, and enhancement mechanisms of disclosure. This approach essentially assumes that the compliance norm will ensure that the good-faith firm manager will abide by the more stringent requirements of fuzzy disclosure, thus triggering the three mechanisms of disclosure. But there is another possibility: firm managers may question the legitimacy of the increasingly complex disclosure requirements and no longer feel normatively bound to comply with them.

Norms scholars have long emphasized the importance of "legitimacy" of the law in the operation of the compliance norm. Tyler and others note that most people view obedience to *legitimate* govern-

208. *Id.* at 241.
209. *Id.* at 243.
210. *See supra* Part II.B.

mental authority as an obligation of citizenship.[211] In this context, government action is legitimate when it is designed and "implemented in accordance with principles of procedural justice."[212] While the concept of procedural justice is the subject of continuing debate, many norms scholars recognize that representation and ethicality are two important components of procedural justice.[213] Representation concerns the extent to which the governed individual or entity has been able to present its concerns in a meaningful way to the civil authority.[214] Ethicality focuses on whether the regulator acted so as to make the regulated person or firm feel respected as a valuable member of society.[215] Where these components are substantially absent, the legitimacy of the government action, and consequently the power of the compliance norm, will be weak.[216]

Much of Tyler's work and that of other norms scholars focused on the compliance of individual citizens with laws unrelated to business operations.[217] Nonetheless, it appears that the relationship between perceived legitimacy of the law and the strength of the compliance norm also holds true in the world of business. In their classic study of corporate compliance, Kagan and Scholz noted that firm managers, interviewed in their study and in other studies, consistently recounted stories of "ill-conceived and conflicting regulations; officious and poorly trained government inspectors, unreasonable paperwork requirements; bureaucratic delay; governmental indifference to the disruption or inefficiencies in productive processes caused by literal enforcement of regulations."[218] Kagan and Scholz and other scholars argue that generally law-abiding corporations may selectively violate regulations perceived to be arbitrary or unreasonable.[219]

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211. Raymond Paternoster et al., *Do Fair Procedures Matter? The Effect of Procedural Justice on Spouse Assault*, 31 LAW & SOC'Y REV. 163, 167 (1997); Tom R. Tyler & John M. Darley, *Building a Law-Abiding Society: Taking Public Views About Morality and the Legitimacy of Legal Authorities into Account when Formulating Substantive Law*, 28 HOFSTRA L. REV. 707, 716 (2000).

212. Malloy, *supra* note 17, at 467-68; *see also* Tyler & Darley, *supra* note 211, at 718-23.

213. Paternoster et al., *supra* note 211, at 167-68; *see also* Tyler & Darley, *supra* note 211, at 737-38. *See generally* E. ALLEN LIND & TOM R. TYLER, THE SOCIAL PSYCHOLOGY OF PROCEDURAL JUSTICE (1988) (providing a survey of the literature on procedural justice).

214. Paternoster et al., *supra* note 211, at 167; Tyler & Darley, *supra* note 211, at 737-38.

215. Paternoster et al., *supra* note 211, at 168.

216. *See* Suchman, *supra* note 21, at 488; TYLER, *supra* note13, at 26-27 (noting the reduced level of obedience where public support of a law is lower).

217. Malloy, *supra* note 17, at 467 (describing Tyler's work regarding laws governing littering, parking, shoplifting, and the like).

218. Robert A. Kagan & John T. Scholz, *The "Criminology of the Corporation" and Regulatory Enforcement Strategies*, *in* ENFORCING REGULATION 67, 75 (Keith Hawkins & John M. Thomas eds., 1984).

219. *Id.* at 75; AYRES & BRAITHWAITE, *supra* note 20, at 21-27; David B. Spence, *The Shadow of the Rational Polluter: Rethinking the Role of Rational Actor Models in Envi-*

Stringent requirements in a fuzzy disclosure provision could trigger concerns regarding representation and ethicality in the minds of firm managers. Regulators must understand that from the manager's perspective, the firm is already subject to a raft of disclosure obligations under state and federal laws. The imposition of a more complicated form of disclosure may be viewed as an offensive intrusion into the firm's internal decisionmaking routines, adding delay and cost to operational decisions with little perceived benefit to the regulatory program. As such, the fuzzy disclosure could be characterized as yet another example of inflexible command-and-control regulation that fails to take the firm's needs into account, and thus reduces the representative aspects of the regulation.[220] Moreover, the firm may take the heightened standard of fuzzy disclosure as a reflection of distrust and the apparent disregard of the delays and costs caused by the provision as a sign of disrespect. This perspective could undermine the perceived ethicality of the fuzzy disclosure program.[221] These potential reactions thus raise the possibility that the compliance norm could have reduced impact on a given firm's decision regarding fuzzy disclosure.

It is difficult to quantify the risk that fuzzy disclosure will lead to a breakdown of perceived procedural legitimacy and thus undermine the compliance norm. In any given instance, much will depend on the past history and current structure of the regulations governing the targeted industry, as well as the quality of the relationship between the regulator and the regulated sector and its constituent firms. And the regulator could perhaps reduce the risk through education and meaningful engagement of the relevant industry players in rule development and implementation. Nonetheless, the existing literature on compliance and norms sets out a strong caution for regulators seeking to rely upon the compliance norm in this and other contexts.

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ronmental Law, 89 CAL. L. REV. 917, 983 (2001).

220. Malloy, *supra* note 17, at 469.

221. *Id.*